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Beneficial ownership: CJEU Landmark ruling

Jonathan Schwarz (Temple Tax Chambers; King's College London) · Wednesday, February 27th, 2019

The judgements of the CJEU in *N Luxembourg 1 v Skatteministeriet* (Case C-115/16) and joined cases and in *T Danmark* (Case C-116/16) and another joined case, on 26 February 2019, once again addressed numerous controversies over meaning of the term "beneficial ownership". The court's concern in *N Luxembourg* was qualification for relief from withholding tax on interest and royalties pursuant to article 1 of the EU Interest and Royalties Directive (*Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States*. *T Danmark* concerned relief from withholding tax on dividends pursuant to the EU Parent-subsidiary Directive (*Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, as amended by Council Directive 2003/123/EC of 22 December 2003*).

This decision follows recent decisions of the Korean Supreme Court on the meaning of the same term in Korean double tax treaties with Hungary and Ireland.

Common law origin

Beneficial ownership, a term imported into tax treaties from common law, has been the source of much controversy. In recent years this controversy was triggered by the English Court of Appeal decision in *Indofood International Finance Ltd v JP Morgan Chase Bank N.A. London Branch* [2006] EWCA Civ 158. In that case, the court was required to interpret the term in the Indonesia-Mauritius double tax treaty. Tax administrations in a number of countries subsequently sought to challenge entitlement to treaty benefits based on a lack of beneficial ownership, with litigation often ensuing. This controversy ultimately resulted in the 2012 OECD consultation for revised Commentary on the meaning of beneficial ownership in articles 10,11 and 12 of the Model. The conclusions of this consultation were included in Commentary to the 2014 OECD Model. Despite the revised Commentary bringing some much needed clarity to the issue, disputes have continued.

While the EU Parent-subsidiary Directive, enacted in 1990, does not include a beneficial ownership requirement, the Interest and Royalties Directive grants exemption from withholding tax only where the recipient is the beneficial owner of the payment. The CJEU has now given judgement on a number of issues in connection with five fact patterns involving dividends, interest and royalties.

Meaning of Beneficial ownership

On the central question of the meaning of beneficial ownership, the CJEU ruled that in the Interest and Royalties Directive, the term designates an entity which actually benefits from the interest that is paid to it. This follows from Article 1(4) of the Directive which elaborates on the meaning by stating that a company of a Member State is to be treated as the beneficial owner of interest or royalties only if it receives those payments for its own benefit and not as an intermediary, such as an agent, trustee or authorised signatory, for some other person. This the court says confirms a reference to economic reality. Thus the court ruled that a 'beneficial owner' is not a formally identified recipient, but rather, an entity which benefits economically from the interest received and, accordingly, has the power freely to determine the use to which it is put.

The court noted that the term in the directive must be given an autonomous EU law meaning and not the domestic meaning under the law of the member state applying the directive. This may be different from double tax treaties where article 3(2) of the OECD Model may require a reference to a domestic law meaning. In *Prevost Car Inc. v. The Queen*, 2008 TCC; 231 affd., 2009 FCA 57, the Tax Court of Canada ruled that the domestic meaning applied by reason of article 3(2), but that this was consistent with the ordinary meaning of the term.

In *N Luxembourg 1*, the CJEU noted that the equivalent wording in other languages has a variety of entirely different linguistic connotations. This suggested that economic benefit was the common feature in all languages. The need for a single EU law meaning in the directive may distinguish the directive meaning from that in bilateral tax treaties, where the ordinary meaning in different languages could explain the different approaches that other courts have taken when interpreting the term in double tax treaties.

OECD Model Treaty and Commentary

The role of the OECD Model and Commentary as a source for interpretation of the term in the directive is acknowledged by the CJEU. As a result, when the court says that a conduit company cannot be a beneficial owner, this must be taken to mean – only in the circumstances identified in the OECD Commentary. That is where, though the formal owner, the owner has, as a practical matter, very narrow powers which render it, in relation to the income concerned, a mere fiduciary or administrator acting on account of the interested parties.

Beneficial ownership and abuse of law

Beneficial ownership describes a particular kind of ownership of property or a right that is not merely formal, nominal or fiduciary. Inclusion of this term to qualify entitlement for treaty or directive benefits, may prevent such benefits from accruing in inappropriate circumstances, specifically, where the recipient of the payment is not taxable as a result of only having a formal, nominal or fiduciary ownership. That dos not mean that the absence of beneficial ownership equates to abuse in the EU law sense, namely, artificial transactions devoid of any economic and commercial justification, with the essential aim of improperly benefiting from a tax advantage.

Although the CJEU does not explicitly say so, the two concepts are intertwined in its analysis that aims to answer the many questions put to it by the Danish court, in a different manner from the way the questions were put. The Danish court asked whether the beneficial ownership requirement in a treaty between Member States, is an agreement-based anti-abuse provision within article 5 of the Interest and Royalty Directive and article 1 of the Parent-subsidiary Directive. This is of special importance in the Parent-subsidiary Directive which does not have its own beneficial ownership

requirement. If beneficial ownership is such an agreement-based anti-abuse provision, then the application of the directive may be subject to its requirements.

Instead of answering this question, the CJEU confirms the general legal principle that EU law cannot be relied on for abusive or fraudulent ends. As a result, it is unnecessary for a domestic or agreement based anti-abuse provision to exist n abusive cases for the directives to be disapplied. The court then discusses indicators of abuse, including conduit companies and the burden of proof. In the context of the burden of proof of abuse, the court indicates that beneficial ownership and abuse are each distinct concepts.

Korean Supreme Court: Beneficial ownership or abuse of law

The Korean Supreme Court ruled in *Corning*, Decision 2018Du38376, decided November 29, 2018, that a beneficial owner in article 10 of the Hungary-Korea double tax treaty is "a person who is entitled to enjoy benefits of the dividend income received and who is neither bound by law nor by contract to retransfer the relevant dividend income to another person". The court noted evidence that the Hungarian company was an ordinary business entity, functioning as an intermediary holding company and a service centre. It conducted relevant business activities in Hungary over a prolonged period pursuant to an independent business purpose, that is, a restructuring of the multinational group. In that connection, it controlled and managed the shares of the Korean dividend paying company and the dividend income in the same way as other assets it owned. It did not distribute the dividends on to its US parent company. The Hungarian company was accordingly the beneficial owner of dividends paid to it by the Korean company.

In contrast, in an as yet unpublished decision on 27 December 2018, the Korean Supreme Court concluded that an Irish subsidiary of a US parent was not the beneficial owner of patent royalties paid to it by a Korean affiliate to the Irish subsidiary. The reasons included the lack of commercial purpose for its existence in Ireland aside from tax avoidance, modest share capital and only three employees. More than 90% of the royalties were paid by the Irish company to the US company.

Substance v beneficial ownership

If these Korean cases were analysed in light of the current approach of the CJEU, the factors regarded relevant to beneficial ownership by the Korean court would, instead, be relevant to abuse or "substance".

The CJEU decisions undoubtedly represent a landmark on beneficial ownership. They raise a number of important issues that require close examination including the relationship between double tax treaties and EU directives. This voyage of discovery is certainly not at an end.

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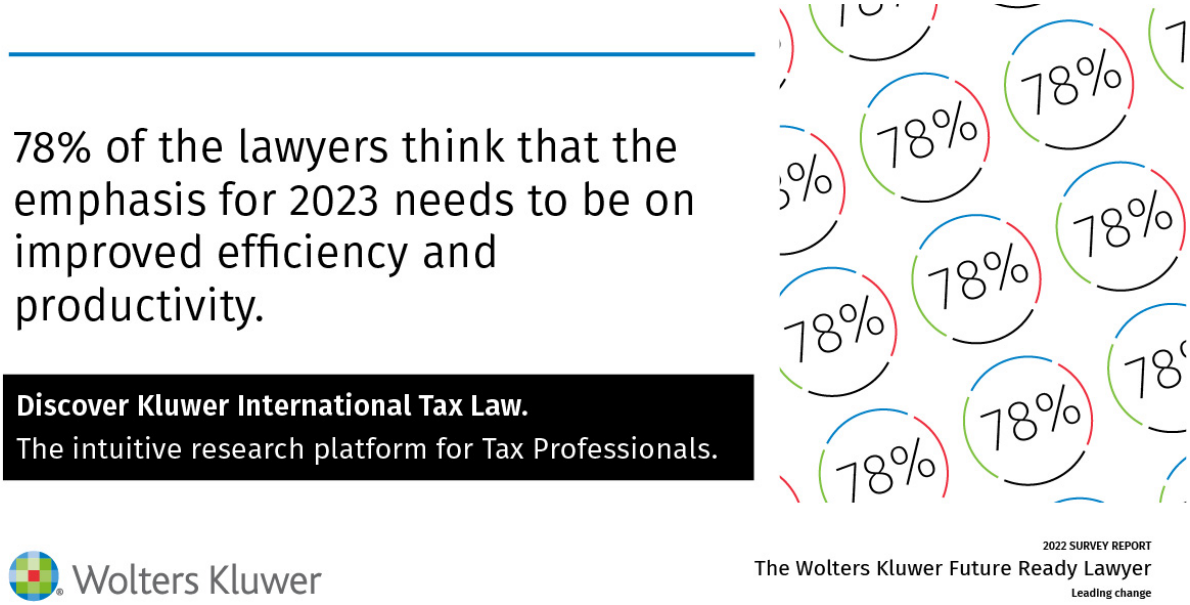

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