

## Beneficial Ownership in International Financing Structures

by Jakob Bundgaard and Niels Winther-Sørensen

Reprinted from *Tax Notes Int'l*, May 19, 2008, p. 587

## Beneficial Ownership in International Financing Structures

by Jakob Bundgaard and Niels Winther-Sørensen

Jakob Bundgaard is an associate professor with the Law Department of the Copenhagen Business School and a director with Deloitte, Copenhagen. Niels Winther-Sørensen is a professor with the Law Department of the Copenhagen Business School.

This article is based on an earlier article (in Danish), which was published in *SR-Skat* 2007, vols. 5 and 6.

### I. Introduction

#### A. The Problem

The notion of beneficial ownership has been attracting increasing attention because of the wide use of international financing structures and holding company structures. Recent court cases have addressed the problem, which has given tax authorities an opportunity to thoroughly scrutinize international financing structures.<sup>1</sup> This article is inspired by this development and the prospect of future litigation on the subject.

The overall aim of this article is to analyze the concept of beneficial ownership in international tax law with emphasis on international financing structures. The issue is analyzed by examining treaty interpretation, directive interpretation, and domestic law using Denmark as an example (because Denmark introduced withholding tax on interest payments effective April 1, 2004).

Withholding tax on interest gained significant practical importance because international financing structures and U.S. investors often use the interposition of financing companies resident outside the EU that have

not entered into a tax treaty with Denmark. If interest payments from Denmark are received by a group company resident in a non-tax-treaty or non-EU state, a domestic withholding tax on interest is triggered in several countries. This is rarely the case with interest payments made to companies in tax treaty or EU states.

In any scenario when payment of dividends, royalties, or interest may trigger withholding tax in the source state, it is of obvious concern whether the withholding tax may be avoided by claiming protection from existing tax treaties or EU company tax law directives. Thus, it is an important challenge in international tax law to analyze the impact on these structures by beneficial ownership clauses in tax treaties and the EU interest and royalty directive. Moreover, the treatment in domestic law should be analyzed.

The analysis of beneficial ownership involves the three dimensions of international tax law: domestic tax law, tax treaties, and EU tax law. This article will analyze in Section II the notion of beneficial ownership according to tax treaties based on the OECD model. This is followed by an analysis in Section III of beneficial ownership under the EU interest and royalty directive. Section IV analyzes identification of the beneficial owner under Danish domestic law. Finally, we draw conclusions in Section V.

#### B. Presentation of Base Case

Foreign companies are liable for Danish withholding tax on interest payments paid from a Danish company,

---

<sup>1</sup>Most recently, the subject was included in the 2007 International Fiscal Association congress in Kyoto, Japan. See "Conflicts in the Attribution of Income to a Person," *Cahiers de Droit Fiscal International*, Vol. 92b.

if the paying Danish company and the recipient company are related.<sup>2</sup> The limited tax liability also includes capital gains on claims arising from debt redeemed with a premium agreed in advance, which under domestic Danish tax law are characterized as capital gains.

Limited tax liability is not triggered by interest payments insofar as the taxation is reduced or eliminated according to the interest and royalty directive or a tax treaty with the state of residence of the recipient company. A direct loan from a related company in a non-EU or non-tax-treaty state to a Danish related company will trigger a Danish withholding tax of 30 percent of the paid interest.<sup>3</sup> This is not the case with payments to related companies resident in EU or tax treaty states.

To avoid the Danish withholding tax, one or more companies are interposed between Denmark and the ultimate recipient company resident in a non-EU/non-tax treaty state. The interposed company is then considered to be a formal creditor regarding the loan to the Danish debtor company. Similar “treaty sandwich” or back-to-back loan structures are widely used throughout the world.

The interest received by the interposed company is generally taxable according to domestic rules in the EU or tax treaty state. In many situations, the interposed company will only be taxable on the net interest income (an arm’s-length spread) because the interposed company has provided the funds by way of debt financing from other related companies.

A commonly seen (but simplified) financing structure is shown in the figure on the following page.

In this example, Caymanco Ltd. is a company resident in a non-EU/non-tax treaty state (Cayman Islands). Interest income from loan 1 is typically tax exempt or taxed at a very low level in the tax haven according to domestic legislation. The debtors’ (Luxco Sarl.) state of residence does not levy withholding tax on interest payments because interest payments on loan 1 are tax exempt in Luxembourg. Luxco Sarl. is fully taxable in Luxembourg. The company is taxable in Luxembourg from the interest income received from loan 2. However, this taxable income is similar to an arm’s-length interest payment on loan 1. Accordingly, only a spread will be taxable in Luxembourg.

<sup>2</sup>See section 2(1)(d) and (h) of the Danish Corporate Tax Act (CTA).

<sup>3</sup>See section 65 D of the Danish Source Tax Act. The interest tax of 30 percent is being lowered to 25 percent, which is equal to the Danish corporate tax rate. The reason for lowering the withholding rate is to make sure that the Danish legislation is in line with the fundamental freedoms under the EU Treaty. See Bill no. L 31, Jan. 2008.

Interest payments received by Luxco Sarl. from DK A/S are not taxable in Denmark. This result assumes that Luxco Sarl. is considered the beneficial owner of the interest income from loan 2. If Caymanco Ltd. is considered the beneficial owner of the interest income from loan 2, then Caymanco Ltd. would be subject to limited tax liability in Denmark for the interest payments, and DK A/S would be obliged to withhold the interest tax.<sup>4</sup>

Consequently, it is necessary to determine (1) how the notion of beneficial ownership should be understood, as this is crucial to the tax treatment of international financing structures and (2) whether the tax authorities of the source state by reference to the concept of abuse either in tax treaties or domestic law or on the basis of other viewpoints may claim that Luxco Sarl. cannot obtain protection under tax treaties or under the interest and royalty directive.

This analysis presupposes that all loans are at arm’s length.<sup>5</sup> Moreover, the analysis assumes that loan transactions are classified as debt for domestic tax purposes. Thus, we do not consider the specific issues concerning hybrid financial instruments.<sup>6</sup> Finally, the analysis assumes that the tax treaties in question do not contain clauses similar to Article III in the protocol to the Denmark-U.K. tax treaty, dated July 1, 1991, regarding the change of article 11 of the treaty.

In practice, financing structures are often structured in tiers, whereby one or more companies are interposed between Luxco Sarl. and Caymanco Ltd.

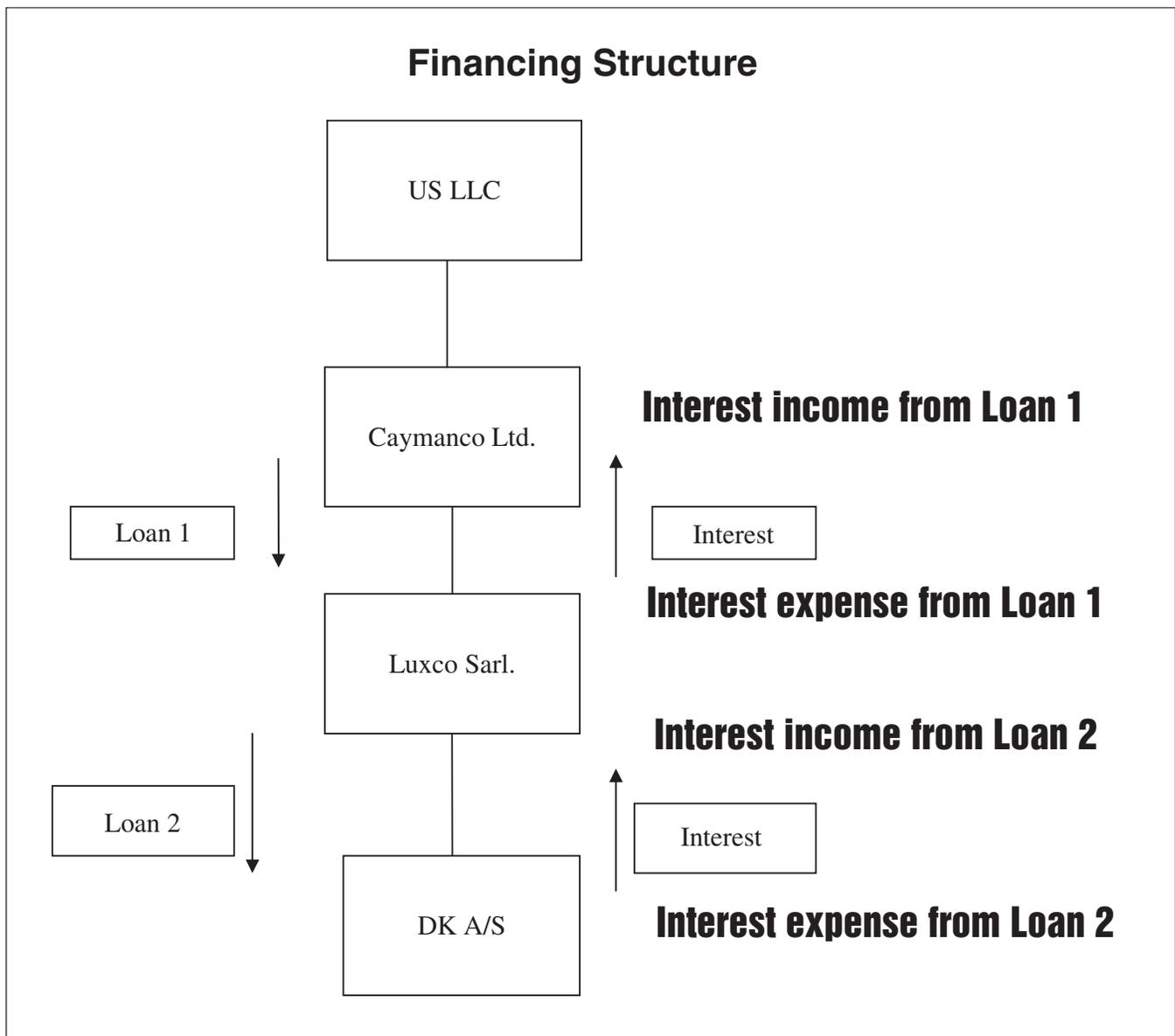
One may consider a situation in which:

- the only function of Luxco Sarl. is to provide the loan to DK A/S;
- the size of the loan and the terms regarding interest payments and repayments are identical to the loan received by Luxco Sarl. from Caymanco Ltd.;
- Luxco Sarl. does not have any capital of any significance;
- the claim of Luxco Sarl. is used as collateral for the company’s own loan from Caymanco Ltd.; and
- nonrecourse terms have been agreed upon, whereby Luxco Sarl. may avoid repaying its debt

<sup>4</sup>See section 65 D of the Danish Source Tax Act.

<sup>5</sup>Based on the control efforts by the Danish tax authorities (SKAT) regarding the activities of international private equity funds in Denmark (as published in the report dated Mar. 20, 2007, p. 2), there is a significant difference in which interest rates are used in intragroup transactions compared to bank loans. The interest payments in some cases are more than twice the level of bank loans.

<sup>6</sup>See, e.g., Jakob Bundgaard in *Skat Udland* 2006, p. 391.



to Caymanco Ltd. to the extent DK A/S fails to repay its debt to Luxco Sarl.

In a situation such as this, the significant risk should be considered up front that the tax authorities in several states will conclude that withholding tax may be levied and is not restricted by the tax treaties or the interest and royalty directive.

However, one may consider a situation in which Luxco Sarl. carries out other activities not related to DK A/S, that Luxco Sarl. has a significant capital, and that no direct connection exists between the loan from Luxco Sarl. to DK A/S and the loan from Caymanco Ltd. to Luxco Sarl.

The situations described above will hardly give rise to doubt. Few corporate taxpayers would consider

engaging in tax planning as described in the first situation, whereas tax authorities would hardly challenge taxpayers in the second situation. Financing structures used in practice contain elements from both ends of the spectrum.

## II. Beneficial Ownership in Tax Treaties

In article 11, paragraph 2 of the OECD model income tax treaty, the right to tax in the source state is limited to 10 percent of the gross interest payments when the beneficial owner of the interest is resident in the domicile state.

According to domestic law in some countries (including Denmark), withholding tax is not levied in situations when the right to tax is reduced according to

a tax treaty or the interest and royalty directive. A well-developed network of tax treaties exists within the EU. From a practical point of view, a natural starting point is to analyze when a source state should reduce or eliminate the taxation of interests.

The example presented in Section I involves Luxco Sarl. as the receiving company. The company, being resident in Luxembourg, is entitled to protection under the Denmark-Luxembourg treaty.<sup>7</sup>

The notion of beneficial ownership as used in the OECD model treaty is analyzed to predict whether companies like Luxco Sarl. may claim treaty protection regarding the interest payments from the company in the source state. Moreover, we will analyze whether national tax authorities may deny treaty protection because of arguments based on the abuse of law at the treaty level. The discussion is illustrated by reference to Danish law.

### A. Article 11 of the OECD Model

The notion of “beneficial owner” was introduced for the first time in articles 10-12 of the 1977 OECD model. Article 11 states:<sup>8</sup>

1. Interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.
2. However, such interest may also be taxed in the Contracting State in which it arises and according to the laws of that State, but if the recipient is the beneficial owner of the interest the tax so charged shall not exceed 10 percent of the gross amount of the interest.

The notion of beneficial ownership is not defined in the OECD model or the commentary. The commentary to the 1997 model states:<sup>9</sup>

Under paragraph 2, the limitation in the State of source is not available when an intermediary, such as an agent or nominee, is interposed between the beneficiary and the payer, unless the beneficial owner is a resident of the other Contracting State. States which wish to make this more explicit are free to do so during bilateral negotiations.

<sup>7</sup>See article 1.

<sup>8</sup>The fact that the notion of beneficial owner is found in paragraph 2 and not in paragraph 1, as is the case in some tax treaties, is of no importance. The notion of beneficial owner in article 11, paragraph 2 is connected to the limitation of the taxing right of the source state, which is the same function as ensured by paragraph 1 in other situations.

<sup>9</sup>See OECD commentary (1977 version) to article 11, no. 8.

Moreover, the issue was briefly mentioned in article 1 of the commentary with a reference to articles 10-12 of the OECD model.<sup>10</sup>

The OECD commentary on article 1 regarding treaty abuse was expanded markedly by the 1992 revision to the OECD commentary to article 1. Thus, reference is made to two reports from the Committee on Fiscal Affairs from 1987. In the OECD commentary, possible solutions are proposed to the contracting states.<sup>11</sup>

In the 1995 revision, the wording of article 11, paragraph 2 was amended, changing the phrase, “but if the recipient is the beneficial owner of the interest the tax so charged shall not exceed 10 percent of the gross amount of the interest,” to, “but if the beneficial owner of the interest is a resident of the other Contracting State, the tax so charged shall not exceed 10 percent of the gross amount of the interest.”<sup>12</sup>

In the 2003 revision, the OECD commentary to article 11 was expanded.<sup>13</sup> Compared to previous versions, the changes indicate that the notion of beneficial ownership is not to be understood in a narrow technical sense, but should be viewed in light of the overall purpose and intent of the model treaty concerning avoidance of double taxation and prevention of tax abuse and tax avoidance.

First, it would not be in accordance with the intent and the purpose of tax treaties if the source state grants relief by payments to agents or nominees when intermediaries are not taxed in their state of residence, which again will not lead to double taxation. Second, it is stated regarding conduit companies:<sup>14</sup>

It would be equally inconsistent with the object and purpose of the Treaty for the State of source to grant relief or exemption where a resident of a Contracting State, otherwise than through an agency or nominee relationship, simply acts as a conduit for another person who in fact receives the benefit of the income concerned. For these reasons, the report from the Committee on Fiscal Affairs entitled “Tax treaties and the Use of

<sup>10</sup>See OECD commentary (1977 version) to article 1, no. 9.

<sup>11</sup>See OECD commentary (1992 version) to article 1, no. 11.

<sup>12</sup>The change clarified that the state of source should also reduce the source taxation if an upper tier is the beneficial owner rather than the immediate recipient and the beneficial owner is resident in the same state as the immediate recipient. Thus, the crucial point is the place of residence for the beneficial owner. This interpretation is similar to the practice followed by all member states according to the 1977 version of the OECD model.

<sup>13</sup>The existing commentary to article 11, in no. 8, was in 2003 moved to no. 8.2 and in the 2005 revision to no. 11. The 2003 revision also introduced a new commentary in nos. 8 and 8.1.

<sup>14</sup>See OECD commentary (2005 version) to article 11, no. 10.

Conduit Companies” concludes that a conduit company cannot normally be regarded as the beneficial owner if, though the formal owner, it 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. [Footnotes omitted.]

The case law in many countries (including Denmark) acknowledges that the OECD commentary can be considered when interpreting tax treaties.<sup>15</sup> If the OECD model has been changed since the actual tax treaty was agreed, it is often a question of which version of the OECD model should be applied.<sup>16</sup> The OECD commentary implies that later versions could be included in the interpretation if they do not state a change to the OECD model. Changes in the OECD commentary may express a clarification and not a change.<sup>17</sup> If changes in the OECD commentary are considered a direct change, the changed commentary can hardly be applied regarding existing tax treaties.<sup>18</sup>

When concluding which version of the OECD commentary to apply, it may be argued that the changes to the OECD commentary are merely a clarification rather than a change in policy.<sup>19</sup>

## B. An Autonomous International Fiscal Meaning

The notion of beneficial ownership is not defined in the OECD model or in most tax treaties. It is debatable whether the notion of beneficial ownership should be understood in accordance with an autonomous international meaning or with reference to domestic law.<sup>20</sup>

This article analyzes whether interest payments covered by the tax treaty agreed with the state of the formal interest recipient (Luxco Sarl. in the example) under the assumption that the notion of beneficial ownership should be interpreted autonomously according to an international fiscal meaning. In Section II.C, we analyze whether it may be expected that Danish tax authorities and courts will include domestic law in the context of interpreting the notion of beneficial ownership in tax treaties. In Section II.D, we examine to what extent more general considerations regarding abuse of tax treaties may be included when considering whether conduit companies should be subject to tax treaty protection regarding interest payments.

### 1. The 1987 OECD Report

The starting point of this analysis is the 1987 OECD report, which formed the basis of the 1997 version of the OECD model.<sup>21</sup>

According to the report, it should be considered whether in actual situations we are dealing with a stepping stone conduit company.<sup>22</sup> The report states that the interpretation of article 4 in some instances will result in a situation in which treaty protection may not be granted in the source state. Regarding the notion of beneficial owner, the report refers to the 1977 version of the OECD commentary and states:<sup>23</sup>

The Commentaries mention the case of a nominee or agent. The provisions would, however, apply also to other cases where a person enters into contracts or takes over obligations under which he has similar function to those of a nominee or an agent. Thus, a conduit company can normally not be regarded as the beneficial owner if, through the formal owner of certain assets, it has very narrow powers which render it a mere fiduciary or an administrator acting on account of the interested parties (most likely the shareholders of the conduit company). In practice, however, it will usually be difficult for the country of source to show that the conduit company is not the beneficial owner. The fact that its main function is to hold assets or rights is not itself sufficient to categorise it as a mere intermediary, although this may indicate that further examination is necessary. This examination will in any case be highly burdensome for the country of source, and not even the country of residence of the conduit company may have the necessary information regarding the shareholders or other interested parties or the decision-making process of the conduit company. So even an exchange of

<sup>15</sup> See the following cases from Danish case law: *TjS* 1992, 291 Ø; *TjS* 1993, 7 H, 1996, 715 Ø; *TjS* 2000, 426 Ø; and *National Assessment Guide* 2006-3, D.D.2.

<sup>16</sup> See Klaus Vogel, *Doppelbesteuerungsabkommen Kommentar*, 4th ed., Einleitung, margin no. 127; Aage Michelsen, “Revision & Regnskabsvæsen,” 2003 *SM* 133; and Niels Winther-Sørensen, *Beskatning af international erhvervsindkomst*, p. 77 et seq.

<sup>17</sup> See OECD commentary (2005 version), Introduction, no. 33; Hugh J. Ault, *Intertax* 1994, p. 144; and Klaus Vogel, *Doppelbesteuerungsabkommen Kommentar*, 4th ed., Einleitung, margin no. 129.

<sup>18</sup> See *TjS* 2003, 222 H, and for commentary, Aage Michelsen, *International skatteret*, 3rd ed., pp. 65 and 184; Niels Winther-Sørensen, *Skat Udland* 2000, p. 326.

<sup>19</sup> See Klaus Vogel, *Doppelbesteuerungsabkommen Kommentar*, 4th ed., 2003, Vor Art. 10-12, margin no. 17.

<sup>20</sup> Other authors have used another line of reasoning to describe the notion of beneficial ownership by first looking at a potential definition in the tax treaty in question; see Jack Bernstein, “Beneficial Ownership: An International Perspective,” *Tax Notes Int’l*, Mar. 26, 2007, p. 1211, *Doc* 2007-3554, or 2007 *WTD* 60-8; Marco Q. Rossi, “An Italian Perspective on the Beneficial Ownership Concept,” *Tax Notes Int’l*, Mar. 19, 2007, p. 1117, *Doc* 2007-1569, or 2007 *WTD* 58-9.

<sup>21</sup> See OECD Committee on Fiscal Affairs, *International Tax Avoidance and Evasion — Four Related Studies*, 1987, p. 88.

<sup>22</sup> *Id.* at 89.

<sup>23</sup> *Id.* at 93.

information between the country of source and the country of the conduit company may not solve the problem. It is apparently in view of these difficulties that the Commentaries on the 1977 OECD Model mentioned the possibility of defining more specifically during bilateral negotiations the treatment that should be applicable to such companies.

Although it is stated in the report that the notion of beneficial ownership may deny some conduit companies treaty protection in the source state, it is also seen that this should only rarely be the case. Thus, it is a prerequisite that the company “has very narrow powers which render it a mere fiduciary or an administrator acting on account of the interested parties.”<sup>24</sup> In many instances, intermediate holding companies are seen to be the direct or indirect parent company for a number of companies within groups of companies. In these instances the intermediate holding companies are not limited in the access to the assets held by the parent company, including the notes. The mere fact that an intermediate holding company is owned by a company resident in a non-EU/non-tax treaty country should not be sufficient to deny the intermediate holding company treaty protection under a tax treaty with Denmark. Part III of the report contains an analysis of possible treaty provisions (from the 1992 version, and also found in the OECD commentary to article 1). Part IV provides the following general statement regarding tax treaties that have not included specific antiavoidance provisions:

43. Existing treaties may have clauses with safeguards against the improper use of their provisions. Where no such provisions exist, treaty benefits will have to be granted under the principle of “pacta sunt servanda” even if considered to be improper. The Contracting States should, however, be prepared to grant all possible help by exchange of information (cf. paragraph 19 above) and to remedy the situation by adequately revising the treaty (cf. Part III above).<sup>25</sup>

Finally, OECD member states disagree whether domestic antiavoidance provisions may result in a situation in which no double taxation relief is granted.<sup>26</sup>

## 2. OECD Commentary

Reference to the 1987 report was found for the first time in the 1992 version of the OECD commentary.<sup>27</sup> In the 2003 version, a reference was made explicitly in

<sup>24</sup>*Id.* at 93.

<sup>25</sup>*Id.* at 101.

<sup>26</sup>*Id.* at 102.

<sup>27</sup>See OECD commentary to the model treaty (1992 version) to article 1, para. 11.

the commentary to article 11.<sup>28</sup> In the authors’ opinion, the latest versions of the OECD commentary should also be in line with the content of the 1987 report for the Committee on Fiscal Affairs.

The use of the notion of beneficial ownership in article 11 of the OECD model is accounted for below. More recent OECD commentaries should most likely be considered a clarification of the notion of beneficial ownership, which may be included to interpret older tax treaties. Such a result is expected regarding Danish tax law. Even the later OECD commentaries express the same view as stated in the 1987 report from the Committee on Fiscal Affairs, which focuses on potential limitations of the recipient to exercise the ownership of the assets in question, including claims.

## 3. Interpretation in International Tax Law Literature

The notion of beneficial owner derives from the legal traditions of common law,<sup>29</sup> so its meaning is clear in a few countries (such as the United Kingdom and the United States). Many other countries do not use the notion at all.<sup>30</sup> The notions of “nominee,” “legal owner,” and “beneficial owner” reflect the condition that the various functions of the ownership concept in common law are most often shared by more than one person. In its ownership right, the legal tradition of common law typically operates with a differentiation between financial and legal ownership; a beneficial owner relates to the financial ownership.<sup>31</sup>

**The notion of beneficial owner derives from the legal traditions of common law, so its meaning is clear in a few countries.**

In several civil law countries (including Denmark), a similar differentiation is not used between economic and legal ownership. Danish tax law considers the aggregate ownership to be placed with the same person(s). The determination of who is the owner for tax purposes is based on an assessment of who has the power to exercise the normal ownership authorities in terms of private law.

<sup>28</sup>See OECD commentary to the model treaty (2003 version) to article 11, para. 8.1.

<sup>29</sup>See I.A. Tokley, *Company Securities — Disclosure of Interests*, 1995, p. 25.

<sup>30</sup>See Charl P. du Toit, *Beneficial Ownership of Royalties in Bilateral Tax Treaties*, 1999, p. 99.

<sup>31</sup>See IBFD, *ET* 1981, pp. 141 and 143.

An examination of the international tax law commentary shows apparent consensus that the notion of beneficial owner makes it possible to emphasize the actual ownership instead of the formal one.<sup>32</sup> A search for a more precise definition of the notion is, however, frequently in vain.<sup>33</sup> After having established that some purely formal conditions can be disregarded, frequently quotes or references are taken from or made to the OECD's commentary on the model treaty.<sup>34</sup>

Because of the lack of an international tax law meaning of the notion of beneficial ownership, one could argue that the definition must depend on domestic law in the source state.<sup>35</sup> However, it seems that an autonomous international meaning is preferred among the majority of international tax law commentators.

In his analysis of the beneficial ownership notion, Charl P. du Toit has concluded that apart from consensus on the fact that agents and nominees are not considered beneficial owners, there is a great variation in legal theory, from an economic approach in the United States to a purely legal approach in Belgium and France.<sup>36</sup> Du Toit concludes that the following definition may be applied as an autonomous international interpretation: "The beneficial owner is the person whose ownership attributes outweigh [those] of any other person."<sup>37</sup> By this judgment, substance should take precedence over form.<sup>38</sup>

An interpretation based on domestic law is rejected by David B. Oliver, Jerome B. Libin, Stef van Weeghel, and du Toit (*Bulletin* 2000, p. 310, based on an IFA seminar in 1999). The authors also support the existence of an international autonomous definition of beneficial ownership. The authors considered the following three versions of the definition:

- the domestic law meaning in the common law states, imported into the OECD model as a universal meaning;
- a definition that excludes agents and nominees; and

- the person to whom the income is attributable for tax purposes under the law of the residence state or the source state.

Klaus Vogel defined beneficial ownership as: "Nutzungsberechtigter ist also, wer entweder über die Hingabe des Kapitals oder Wirtschaftsgutes zur Nutzung oder über die Verwendung der Nutzungen, gegebenenfalls über beides, entscheiden kann."<sup>39</sup> Vogel states that the definition does not differ significantly from that presented by du Toit. Vogel states that a fully owned company is fully capable of being a beneficial owner. If, however, the company has limited rights regarding assets and remuneration, it may be argued that the company should be considered the beneficial owner.<sup>40</sup>

Philip Baker has commented on the issue regarding dividends.<sup>41</sup> Baker concludes:

This suggests that the term should be accorded an "international fiscal meaning," not derived from the domestic laws of Contracting States. In the absence of a body of established case law on the meaning of the term, the principal source for this international fiscal meaning is the OECD Commentary.<sup>42</sup>

Baker's statements regarding situations in the general example of this article involving a conduit company were given significant weight by the judge in the *Indofood* case. Baker has expressed the following:

The practical question remains whether, for example, a company under the control of another — and therefore likely (though not legally obliged) to pay to its ultimate owner any sums received — could be regarded as beneficial owner of the dividends it receives. Or, to take another example, suppose that a member of a multinational group borrows money and then lends the money on to another group company: the two loans are not tied together, and the lending company is not obliged to use the interest it receives to pay interest on the loan it received — in practice however, it is likely to do so. Adopting the approach of the OECD Commentary (paragraph 12, as amended in 2003), the issue is whether the recipient company is an agent, or a nominee, or a conduit which has, as a practical matter, very narrow powers over the income which render it a

<sup>32</sup>See, however, Joanna Wheeler, *Cahiers de Droit Fiscal International*, Vol. 92b, 2007, 27 et seq., in which the results of the comparative survey are summarized so as to imply considerable variation in the way the notion is interpreted in the various reporting countries.

<sup>33</sup>See, e.g., Joanna Wheeler, *Bulletin* 2005, p. 477.

<sup>34</sup>See Frederik Zimmer, *Internasjonal inntektsskatterett*, 3rd ed., 2003, p. 61; Matthias Dahlberg, *Internationell beskatning*, 2005, p. 294. For an outline of the development of the usage of the notion, see John F. Avery Jones et al., *Bulletin* 2006, p. 246.

<sup>35</sup>Cf. article 3, para. 2 of the OECD model.

<sup>36</sup>See Charl P. du Toit, *Beneficial Ownership of Royalties in Bilateral Tax Treaties*, 1999, p. 170.

<sup>37</sup>*Id.* at 201, 244, and 249.

<sup>38</sup>See Klaus Vogel, *On Tax Treaties*, 1997, p. 562.

<sup>39</sup>See Klaus Vogel, *Doppelbesteuerungsabkommen Kommentar*, 4th ed., 2003, Vor Art. 10-12, margin no. 18. ("Hence, the 'beneficial owner' is he who is free to decide (1) whether or not the capital or other assets should be used or made available for use of others or (2) on how the yields therefrom should be used or (3) both.")

<sup>40</sup>*Id.* at margin no. 19.

<sup>41</sup>Baker, "Tax treaties," article 10, cf. commentary 10B-09 et seq.

<sup>42</sup>*Id.* at commentary 10B-14.

mere fiduciary or administrator. As a practical approach, one can ask whose income the dividends (interest/royalties) are in reality. One way to test this is to ask: what would happen if the recipient went bankrupt before paying the income to the intended ultimate recipient? If the ultimate recipient could claim the funds as its own, then the funds are properly regarded as already belonging to the ultimate recipient. If, however, the ultimate recipient simply is one of the creditors of the actual recipient (if even that), then the funds probably belong to the actual recipient.<sup>43</sup>

In opposition to the opinions presented above, Hans Pijl,<sup>44</sup> and Wim Eynattan, Kurt De Haen, and Niko Hostyn<sup>45</sup> state that a definition in accordance with domestic law is applicable, under article 3. Pijl states that the 2002 version of the OECD model presented a clarification compared to previous versions and that commentary no. 22 to article 10 (inserted with the 1995 version of the OECD model) indirectly supports the view that a recipient of dividends that later distributes the received dividends should not be considered beneficial owner, because that behavior is contrary to the nature of the beneficial owner.

Danish tax law literature has held the view that the notion of beneficial owner has little importance in Danish tax treaties, because it is possible to fulfill the requirement of beneficial ownership by observing the necessary legal formalities.<sup>46</sup> Aage Michelsen states that the provisions in the tax treaties will affect pro forma cases only and that they may prove superfluous, because the same result can be achieved by applying ordinary legal principles.<sup>47</sup>

#### 4. Interpretation in International Case Law

Only limited case law sheds light on the subject of beneficial ownership in international tax law.

The Dutch Supreme Court (Hoge Raad) has decided two cases on the subject.<sup>48</sup> In a case from 1994, a U.K. resident received dividends from a Dutch company. The owner of the shares in the Dutch company was resident in Luxembourg. Although the recipient was not owner of the shares, the Hoge Raad considered the

individual to be a beneficial owner of the dividends. The Hoge Raad found it decisive that the recipient had the right to dispose the received dividends.<sup>49</sup> The ruling demonstrates that the Hoge Raad placed great importance on who was legally entitled to the dividends. The ruling may be used to argue (under tax treaties involving other countries) that a creditor entitled to receive interest and installments and to dispose of the received payments should be considered the beneficial owner of the interests.

In the second Hoge Raad decision on the subject, from 2001, a stock dealer acquired an option the day before the distribution of dividends. The acquisition of the option was based on a business reason to realize a gain and not for the purpose of avoiding withholding tax. The Hoge Raad found that the recipient should be considered the beneficial owner.<sup>50</sup>

A decision that received a great deal of international attention was the U.K. Court of Appeal's *Indofood* case.<sup>51</sup> The case involved a private law dispute. Indofood is an Indonesian company that in 2002 raised capital by issuing corporate bonds on the international market. A 20 percent withholding tax would be levied if the issuance of bonds was carried out directly by Indofood. To avoid this withholding tax, the bonds were instead issued by a wholly owned subsidiary on Mauritius. The issuing subsidiary on Mauritius relented the proceeds from the bonds to Indofood, and the Indonesian withholding tax on the interest payments under the tax treaty between Indonesia and Mauritius was reduced to 10 percent. JP Morgan was appointed trustee of the note holders. According to the terms of the issue, the bonds could be redeemed prematurely if significant changes in Indonesian law would result in a withholding tax of more than 10 percent, unless the issuer by "reasonable measures" could avoid the effects thereof. The Indonesia-Mauritius tax treaty was abolished in 2005, resulting in a 20 percent withholding tax. Indofood wanted to make use of the redemption right through the abolished tax treaty and because the withholding tax could not be avoided by reasonable

<sup>43</sup>*Id.* at commentary 10B-15.

<sup>44</sup>See Hans Pijl, *Intertax* 2003, p. 353.

<sup>45</sup>See Wim Eynattan, Kurt De Haen, and Niko Hostyn, *Intertax* 2003, p. 523.

<sup>46</sup>See Aage Michelsen, *International skatteret*, 2003, p. 427; Steen Askholdt, *Cahiers de droit fiscal international*, 1987, p. 281; Henrik Calum Nielsen, *R&R* 1986, p. 304; Nikolaj Bjørnholm and Anders Oreby Hansen, *Lempelse af dobbeltbeskatning*, 2002, p. 449; and Jørn Quiste and John F. Avery Jones, *R&R* 1985, p. 241.

<sup>47</sup>See Aage Michelsen, *International skatteret*, 3rd ed., 2003, p. 427.

<sup>48</sup>See Rossi, *supra* note 20.

<sup>49</sup>See Pijl, *supra* note 44; Marjaana Helminen, *European Taxation* 2002, p. 454; Eynattan, De Haen, and Hostyn, *supra* note 45.

<sup>50</sup>See Helminen, *supra* note 49.

<sup>51</sup>*Indofood International Finance Ltd. v. JP Morgan Chase Bank N.A. London Branch*, London Branch, Court of Appeal (United Kingdom) of Mar. 2, 2006. See also McGowan, "Indofood Court Expands Interpretation of Beneficial Ownership," *Tax Notes Int'l*, June 26, 2006, p. 1091, *Doc 2006-11587*, or *2006 WTD 117-2*; John F. Avery Jones et al., *Bulletin* 2006, p. 247; Rossi, *supra* note 20; Bernstein, *supra* note 20; Sheppard, "Indofood and Bank of Scotland: Who Is the Beneficial Owner?" *Tax Notes Int'l*, Feb. 5, 2007, p. 406, *Doc 2007-2536*, or *2007 WTD 25-8*; Philip Baker, *Grays Inn Tax Chamber Review*, Vol. VI, No. 1, Feb. 2007, p. 15, available at <http://www.taxbar.com/gitc.html>; and Christiana HJI Panayi, *European Taxation* 2007, p. 457.

measures. JP Morgan, however, claimed that the increased withholding tax on interest could be avoided by using a Dutch special purpose vehicle (SPV) resulting in a reduced withholding tax rate according to the Indonesia-Netherlands tax treaty. Indofood claimed that the structure as proposed by JP Morgan would not be successful because the Dutch SPV would not be considered the beneficial owner of the interest payments.

The High Court upheld JP Morgan's claim. However, the Court of Appeal ruled in favor of Indofood's claim. Thus, it was established that the SPV should not be considered the beneficial owner according to the Indonesia-Netherlands tax treaty.

According to the Court of Appeal, the notion of beneficial ownership should be understood according to an international fiscal meaning, which could not be deduced from the domestic law of the contracting states. The court supported this conclusion by the OECD commentary and Baker's commentary. In paragraph 42 of the decision, the court stated:

As shown by those commentaries and observations, the concept of beneficial ownership is incompatible with that of the formal owner who does not have the full privilege to directly benefit from the income.

The result was further supported in paragraph 43, which stated that the legal, commercial, and practical structure behind the corporate bonds was inconsistent with granting treaty protection to the issuer or an interposed company. Further, the substance is the essence when understanding beneficial ownership. Paragraph 44 of the decision stated that:

In both commercial and practical terms the Issuer is, and Newco would be, bound to pay on the Principal Paying Agent that which it receives from the Parent Guarantor. This is recognised by what we were told actually happens now as recorded in paragraph 13 above. The Parent Guarantor is bound to ensure that such an arrangement continues lest it is required to pay again under its guarantee to the noteholders contained in the Trust Deed. In practical terms it is impossible to conceive of any circumstances in which either the Issuer or Newco could derive any "direct benefit" from the interest payable by the Parent Guarantor except by funding its liability to the Principal Paying Agent or Issuer respectively. Such an exception can hardly be described as the "full privilege" needed to qualify as the beneficial owner, rather the position of the Issuer and Newco equates to that of an "administrator of the income."

The Court of Appeal found support in the purpose of the agreed tax treaties.

The decision supports an international fiscal meaning of the notion of beneficial ownership focusing on

the actual disposal over the asset in question. The tax authorities of several countries have reacted with interest to the *Indofood* decision.

As the most recent development, the Bank of Scotland decision delivered by the French Conseil d'État should be mentioned.<sup>52</sup> The case concerned a wide-spread tax arrangement (usufruct agreements) that was based on now-repealed French legislation. The case also concerned dividends from a French company that had a U.S. parent company. In 1992, the U.S. parent sold a three-year right to receive predetermined dividends deriving from nonvoting preference shares in the French company to Bank of Scotland. The payment to the seller (the U.S. parent) corresponded to three years' worth of net dividends (before withholding tax). Under this usufruct agreement, the U.S. parent also owned 100 percent of the ordinary shares in the French subsidiary. On payment of dividends from the French company, a withholding tax of 25 percent was withheld. In 1993 Bank of Scotland requested that the French tax authorities issue a refund of the portion that exceeded the maximum rate of 15 percent permitted under article 9(6) in the France-U.K. tax treaty. Bank of Scotland also asked for a tax credit (*avoir fiscal*) under article 9(7) of the treaty. This request was denied by the French tax authorities, which found that it was not Bank of Scotland, but the U.S. parent, that was the beneficial owner of the dividends. The argument was that the case concerned a three-year loan agreement between Bank of Scotland and the U.S. parent, in which Bank of Scotland, as payment, was granted access to obtaining an *avoir fiscal*. The company's complaint was dismissed at the court of first instance, then upheld in the second instance, before finally being dismissed by the Conseil d'État. The Conseil d'État stated that Bank of Scotland could not be considered the beneficial owner under article 9(6) of the France-U.K. tax treaty. Consequently, Bank of Scotland was not entitled to a reduction of the French withholding tax under the agreement, or to an *avoir fiscal*. The Conseil d'État agreed with the interpretation that the case in substance concerned a loan agreement in which the repayment was left to the French subsidiary.

Commentators see this ruling as evidence that the substance-over-form mentality has finally come to

<sup>52</sup>See Conseil d'État, dated Dec. 20, 2006, *Ministre de l'Économie, des Finances et de l'Industrie c/ Société Bank of Scotland*, no. 283314, *Revue de Droit Fiscal* no. 4/2007, p. 34, section 87. See also Xénia Legendre and Hicham Kabbaj, "Substance Over Form in France and the *Bank of Scotland* Decision," *Tax Notes Int'l*, Apr. 9, 2007, p. 171, *Doc 2007-5733*, or *2007 WTD 71-10*; Sheppard, *supra* note 51; Klaus Vogel, *BIT* 2007, p. 311; Panayi, *supra* note 51, pp. 458-459; and Bruno Gibert and Yacine Ouamrane, *European Taxation* 2008, p. 2.

France.<sup>53</sup> However, the ruling does not directly consider the question of whether the notion of beneficial owner should be applied under an autonomous understanding or based on domestic law.

Moreover, the Tax Court of Canada recently ruled in *Prévost Car, Inc. v. The Queen*.<sup>54</sup> The structure involves a Dutch company that was owned by a U.K. company (49 percent) and by a Swedish company (51 percent). The Swedish company had acquired all the shares of a Canadian company in 1995 and immediately thereafter transferred them to the Dutch company. The Swedish company then sold 49 percent of the shares in the Dutch company to the U.K. company. In future years, the Canadian company paid dividends to the Dutch company, which was subject to a 5 percent Canadian withholding tax and was tax exempt at the recipient level in the Netherlands. The question was whether the Dutch company was entitled to the reduced withholding tax rate under the Canada-Netherlands tax treaty. The Canadian tax authorities refused to allow the application of the Canada-Netherlands tax treaty by maintaining that the Dutch company was not the beneficial owner of the dividends. The refusal was based on the Dutch company not having any office, (other) assets, activities, or employees in the Netherlands. The only asset was the shares, and all the expenses were paid by the shareholders. Therefore, a look-through approach was applied, and the dividends paid by the Canadian company were treated as if they had been paid to the U.K. company and the Swedish company directly. Accordingly, 49 percent of the dividends were subject to tax at the 10 percent rate of the Canada-U.K. tax treaty and 51 percent of the dividends were subject to tax at the 15 percent rate of the Canada-Sweden tax treaty.

The Tax Court of Canada gave its decision on April 22, 2008, in the case of *Prévost Car Inc. v. Her Majesty the Queen*. Associate Chief Justice the Hon. Gerald J. Rip decided that the Dutch company was the beneficial owner of dividends paid by the Canadian subsidiary under article 10(2) of the Canada-Netherlands treaty. The judge decided that there was no evidence that the Dutch company was a conduit for its parent companies, and that it was the only person that had any interest in the dividends declared by the Canadian subsidiary.

### 5. Reactions to *Indofood*

As mentioned above, the *Indofood* ruling has given rise to a number of reactions among academics and practitioners in international tax law literature.

<sup>53</sup> See Sheppard, *supra* note 51, at 6; Legendre and Kabbaj, *supra* note 52.

<sup>54</sup> See Panayi, *supra* note 51, at 459.

Chris Adams has stated that it is difficult to assess the significance of *Indofood*, but that the decision is expected to have a larger impact in common law countries than in civil law countries:

In most countries, the expectation is that the decision in *Indofood* merely reinforces the need to ensure that SPVs and other conduits/intermediaries have adequate substance in accordance with the legislation of the relevant jurisdiction.<sup>55</sup>

Philip Baker has also commented on the ruling.<sup>56</sup> Baker takes a positive view on the court's findings — that an international fiscal meaning is to be applied, even though the notion is rather vague.<sup>57</sup> Baker is not surprised by the result:

Recall, the Mauritian company borrowed the identical amount that it on-lent, at the same interest at which it on-lent, and the Court of Appeal found as a fact that the Mauritian company could do nothing with the interest it received but use it to pay the identical amount of interest that it had to pay on. . . . If beneficial ownership had any meaning at all, surely it would exclude the type of interposed entity which had no function whatsoever but to receive income and pay on the identical amount of income: in fact, it had so little function that according to the Court of Appeal, the actual flows of money missed it out completely.<sup>58</sup>

Baker does not find the scope of the ruling as far-reaching as many market players in the United Kingdom have assessed it.

HM Revenue & Customs has published a draft guidance relating to the scope of the *Indofood* decision in the United Kingdom. HMRC considers the decision to be part of domestic law and from now on will observe the guidelines of the decision in U.K. tax treaties.<sup>59</sup>

The Canada Revenue Agency has challenged several structures by applying a wide beneficial ownership notion.<sup>60</sup>

<sup>55</sup> See Chris Adams et al., *World Tax Advisor*, June 2006, p. 28. See also McGowan, *supra* note 51.

<sup>56</sup> See "Beneficial Owner: After *Indofood*," *Grays Inn Tax Chamber Review*, Vol. VI, No. 1, Feb. 2007, p. 15, available at <http://www.taxbar.com/gitc.html>.

<sup>57</sup> *Id.* at 23.

<sup>58</sup> *Id.* at 25.

<sup>59</sup> See draft guidance on HMRC's interpretation of the *Indofood* decision, 2006; see also Metha and Habershon, "U.K. Issues Guidance in Response to *Indofood* Decision," *Tax Notes Int'l*, Nov. 13, 2006, p. 490, *Doc 2006-22678*, or 2006 *WTD 216-2*.

<sup>60</sup> See Bernstein and Summerhill, "Canada Takes Aim at Concept of Beneficial Ownership," *Tax Notes Int'l*, Aug. 28, 2006, p. 737, *Doc 2006-14501*, or 2006 *WTD 16-8*.

### 6. *Impact on the Interpretation of Tax Treaties*

The interest and royalty directive (Directive 2003/49/EEC) article 4 and the savings directive (Directive 2003/487/EEC) article 2 also use the notion of beneficial ownership. Commentators have argued that the European Court of Justice's interpretation should be given importance when the national courts interpret the notion of beneficial owner in tax treaties. Jack Bernstein has suggested that both directives attach importance to whether the interest constitutes a benefit of the recipient, and that the stage is set for a more substance-over-form-based approach.<sup>61</sup>

## The interest and royalty directive and the savings directive also use the notion of beneficial ownership.

However, it is doubtful whether any particular importance can be attached to the EU law interpretation of the notion of beneficial owner in the tax treaties. As outlined above, no decisions exist yet from the ECJ on the interpretation of the notion of beneficial owner. Therefore, it is difficult to transfer the EU law interpretation to the interpretation of the tax treaties.

Whenever the ECJ interprets the notion of beneficial owner, it may serve as inspiration for the interpretation of tax treaties. This interpretation of the notion of beneficial owner in tax treaties will not have any binding effect, but it has significance in the relation between the EU states and in the relation to states outside the EU.

### 7. *Conclusion*

The notion of beneficial owner was introduced in article 11 of the OECD model treaty in the 1977 version without any clear definition in the wording or the comments. Minor adjustments have been made, but an interpretation based on the wording only provides limited guidance to the interpretation of the notion.

The OECD commentary has been changed on an ongoing basis; in the review of the model treaty in 2003, the comments on the beneficial owner concept were expanded. The notion of beneficial owner is not used in a narrow technical meaning, but should be seen in correlation with and in light of the treaty's intention and purpose, including avoiding double taxation and preventing tax evasion and tax avoidance. The

statement on conduit companies is relevant. It must be assumed that the OECD commentary on the model treaty materially express the same views as the report from 1987 from the Committee on Fiscal Affairs, in which a central point is whether the creditor company is limited in its access to having its assets at its disposal, including claims.

There is consensus in international tax law literature that the notion of beneficial owner makes it possible to attach importance to the actual ownership rather than formal ownership. However, a search for a more precise definition of the notion is frequently in vain.

If under the *Indofood* ruling it is assumed that the notion of beneficial owner is to be interpreted autonomously based on an international fiscal meaning, the question arises of what this will imply.<sup>62</sup>

International case law on the notion of beneficial owner is rather limited. In *Indofood*, the court has assumed that the notion of beneficial owner is to be interpreted autonomously, and that focus should be on the actual disposal and return of the asset in question. The ruling should be considered in compliance with the OECD commentary on the model treaty. However, the case concerned a very close correlation between the loan to and from the conduit company.

Based on the OECD commentary, it can be concluded that the notion of beneficial owner based on an autonomous interpretation implies that there is not necessarily any correlation between the formal owner of a claim and the beneficial owner. If a formal owner does not have the right to dispose of a claim and its return, this may imply that the formal owner is not the beneficial owner according to article 11 of a tax treaty. The precise definition of the notion based on an autonomous interpretation is uncertain.

### C. *Interpretation Regarding Domestic Law*

An autonomous interpretation of the notion of beneficial owner provided by international sources of law and international tax practice makes it possible to make some conclusions regarding the contents of the notion of beneficial ownership. However, the notion leaves a number of questions unanswered.

One question is whether the notion of beneficial owner should be interpreted autonomously, or whether the notion should be interpreted in accordance with domestic law under article 3(2) of the OECD model treaty.

<sup>61</sup>See Bernstein, *supra* note 20. A similar interpretation is put forward by Marco Q. Rossi, *supra* note 20.

<sup>62</sup>Baker, *supra* note 51. Baker states that the notion of beneficial owner under an international fiscal meaning is rather vague. Even the Court of Appeal in *Indofood* referred to the OECD comments. Baker does, however, find it unfortunate that the court also expressed that "the substance of the matter" should be emphasized.

<sup>61</sup>See Bernstein, *supra* note 20. A similar interpretation is put forward by Marco Q. Rossi, *supra* note 20.

If interpretations are to be made under domestic law, the interpretation of the treaty will be based on Danish tax law in the example used for illustration. The notion of beneficial owner has not been used in Danish tax law, and it must consequently be assumed that if need be the Danish courts will consider the “rightful recipient” as defined under domestic case law as the beneficial owner under a tax treaty.

There seems to be a general perception among international commentators that the notion of beneficial ownership should be interpreted autonomously, that is, without including domestic law.<sup>63</sup> The disadvantage involved when interpreting with reference to domestic law is that different conclusions are reached in the two states if each state applies its own understanding of domestic law. This disadvantage does not, however, apply if both states involved interpret according to the domestic law of the state of source.<sup>64</sup>

An autonomous interpretation of a notion can also lead to different conclusions. This applies when a notion does not let itself be determined by use of international sources of law, or when the content of the notion remains unclear because international sources of law lead to no clear interpretation. The advantage of providing an interpretation based on domestic law will result in a higher degree of legal certainty.

One of the most material arguments to be presented against interpreting the notion of beneficial owner with reference to domestic law is that domestic law frequently contains no definition. In such circumstances, international literature maintains that the idea of interpreting with reference to domestic law must be dismissed.<sup>65</sup> In Danish case law, however, the Supreme Court (despite a notion in a tax treaty not being defined in Danish tax law on some occasions) has interpreted in compliance with similar notions in Danish tax law. This was the case in *TjS*<sup>66</sup> 1994, 184 H (concerning the interpretation of the residence requirement in the professor provision in article 14 in the then-effective Denmark-U.S. tax treaty) and the majority’s

decision in *TjS* 2003, 222 H (relating to hiring out of labor under the then-effective tax treaty with the U.S. and Canada.). The latter decision has been widely criticized,<sup>67</sup> but case law indicates that the Supreme Court has not abstained from interpreting with reference to domestic law when a relatively clear interpretation is not arrived at by applying the international sources of law, including international tax practice and the OECD model treaty.

The OECD commentary to the model treaty contains only relatively vague guidelines for interpreting the term “beneficial owner.” Only scarce international practice exists on the meaning of the notion of beneficial owner, and international theory cannot present a clear definition either. In other states, tax authorities have taken the view that the notion of beneficial owner should be interpreted with reference to domestic law. In the Netherlands, a national statutory provision on dividends was introduced with effect from 2001. According to the provision, a person is not entitled to treaty relief if the person is not considered to be the beneficial owner. The Dutch government believed that the term “beneficial owner” in the tax treaties was to be interpreted with reference to domestic law because the notion had not been defined in the tax treaties.<sup>68</sup>

## The OECD commentary to the model treaty contains only relatively vague guidelines for interpreting the term ‘beneficial owner.’

It may be assumed that the Danish courts will be inclined, to some extent, to interpret the notion of beneficial owner with reference to Danish tax law. The Danish courts will be inclined to consider the company, which in accordance with a Danish tax law assessment is considered the rightful recipient, as the beneficial owner as well.

### D. Other Countermeasures

The notion of beneficial owner in articles 10-12 of the OECD model treaty may be viewed as antiabuse rules, unless the recipient of dividends, interest, or royalties is the beneficial owner. In the OECD commentary to article 1, the notion of beneficial owner is mentioned in relation to a general discussion on abuse of

<sup>63</sup> See Klaus Vogel, *Doppelbesteuerungsabkommen Kommentar*, 4th ed., 2003, Vor Art. 10-12, margin no. 15; du Toit, *supra* note 30, p. 177; Jerry Libin, *Bulletin* 2000, 310; Helminen, *supra* note 49. However, some authors have maintained that, referring to article 3(2), domestic tax law should be included in the determination of the notion; see Eynattan, De Haen, and Hostyn, *supra* note 45, pp. 523, 538, and 546; Pijl, *supra* note 44.

<sup>64</sup> Technical explanations to the U.S. model treaty have chosen the solution of pointing out a person as beneficial owner to whom income should be allocated according to the tax legislation of the source state; see the explanations to article 11, para. 1, p. 39. Based on this, there is no basis for an international fiscal meaning under U.S. tax treaties; see Bernstein, *supra* note 20.

<sup>65</sup> See du Toit, *supra* note 30, p. 177; Helminen, *supra* note 49, p. 454.

<sup>66</sup> *TjS* is the Danish periodical *Tidsskrift for Skatter og Afgifter*.

<sup>67</sup> See Aage Michelsen, “Revision & Regnskabsvæsen,” 2003 *SM* 133, Jørn Qviste, *Skat Udland* 2003, p. 186; Klaus Vogel, *Bulletin* 2003, p. 236.

<sup>68</sup> See Helminen, *supra* note 49; Pijl, *supra* note 44.

tax treaties; the notion of beneficial owner is used as an example of a special provision aimed at one type of tax avoidance.<sup>69</sup>

The correlation between the notion of beneficial owner and general considerations regarding abuse may give rise to several questions that partly relate to treaties that do not include the notion of beneficial owner and partly to treaties that contain the notion of beneficial owner.

### 1. *Treaties Without Beneficial Ownership Provisions*

If a specific treaty does not include a beneficial ownership provision, it should be determined whether it remains possible for the source state to deny treaty benefits regarding interest payments.

First, we consider whether it is possible — independent of domestic law — to integrate an interpretation of a general antiabuse reservation into the treaty. Second, we consider whether it is possible to apply domestic antiabuse rules, which imply that it is possible in the source state to deny treaty benefits regarding interest payments.

On the first question, there appears to be doubt within international tax law literature.<sup>70</sup> There are no examples in Danish legal or administrative practice of a tax treaty being interpreted independently of the Danish tax law assessment to imply nonapplication of the treaty due to abuse.

The fact that it is possible to arrive at an interpretation in which an antiabuse rule is adopted at treaty level regardless of whether there is a beneficial ownership clause is demonstrated by a decision from Schweizerische Bundesgericht from 2005.<sup>71</sup>

In this particular case, the Swiss tax authorities did not accept a tax-free distribution of dividends from a Swiss-based company to a Danish holding company regarding the Denmark-Switzerland tax treaty. The Danish holding company was owned by a Guernsey-based company, which was owned by a company located in Bermuda. The case concerned an interpretation of the Denmark-Switzerland tax treaty from 1973, which, similar to the 1963 version of the OECD model treaty, did not contain a beneficial ownership clause in articles 10-12.

The Swiss antiabuse rule concerning use of tax treaties was not applicable in the case, which concerned payments of dividends from a Swiss company to a

Danish company.<sup>72</sup> According to Schweizerische Bundesgericht, the decisive point was whether the Denmark-Switzerland tax treaty was applicable in a situation when the Danish holding company was only the first link in a chain of companies established to abuse the tax treaty and, accordingly, avoid Swiss withholding tax on the dividends. The Danish holding company maintained that the Denmark-Switzerland tax treaty did not contain a special abuse provision.

However, Schweizerische Bundesgericht found that a general principle of abuse did apply at the treaty level and that the Swiss tax authorities could deny the Danish holding company the benefit under the Denmark-Switzerland tax treaty. The court further stated that the principle on adjustment on legal abuse is also recognized in Danish tax law,<sup>73</sup> that Denmark in other treaties has antiabuse clauses (for example, in the 1999 treaty with the United States), and that Denmark did not make reservations for the domestic Swiss antiabuse rule at the conclusion of the treaty in 1973. Finally, Schweizerische Bundesgericht found that the treaty should be interpreted in the light of the OECD commentary to the model treaty, including the comments that were incorporated after the conclusion of the treaty between Denmark and Switzerland. The court referred to paragraph 9.4 in the OECD commentary on article 1 (the 2003 version, identical to the 2005 version), which declares that the states are not obliged to grant benefits under a tax treaty in arrangements involving abuse of the treaty's provisions.

Schweizerische Bundesgericht obtained some possible interpretations from the OECD commentary on the model treaty, particularly the transparency clause in paragraph 13 to article 1, even though it has not been included in the treaty between Switzerland and Denmark. The condition that no explicit antiabuse clause had been included in the Denmark-Switzerland treaty implied that no tax adjustment could be obtained if, based on a bona fide assessment, business considerations (and not just the consideration to obtain the benefits under the Denmark-Switzerland treaty) had prompted the claim or if the income was related to a commercial activity in the Danish company.

Since the Danish holding company had no office facilities or staff in Denmark and the company's managing director was resident in Bermuda, Schweizerische Bundesgericht found that no actual commercial activity

<sup>69</sup>See OECD commentary on article 1, para. 10.

<sup>70</sup>See Klaus Vogel, *Doppelbesteuerungsabkommen Kommentar*, 4th edition, 2003, Vor Art. 1, margin no. 117; Stefan Oesterhelt and Marcus Winzap, *ET 2006*, p. 461.

<sup>71</sup>See decision of Nov. 28, 2005, Schweizerische Bundesgericht, II, Öffentlichrechtliche Abteilung in the case *A. Holding ApS gegen Eidgenössische Steuerverwaltung*.

<sup>72</sup>See para. 3.3.1 of the decision; see also Stefan Oesterhelt and Marcus Winzap, *ET 2006*, p. 461; on the domestic Swiss antiabuse rule, see Aage Michelsen, *International Skatteret*, 3rd ed., p. 429.

<sup>73</sup>Schweizerische Bundesgericht referred to Kjeld Lund Andersen in the Danish national report to the IFA congress in 2004, *Cahiers* 89a, p. 265, 269, and 278, and to Jan Pedersen in the Danish national report for 2002, *Cahiers* 87a, p. 233, 241, and 245.

was performed in Denmark. Neither the ongoing commercial operations nor management of the company had any relation to Denmark; the only actual relation to Denmark was the company's formal seat. The Danish holding company had to be considered a letterbox company, and tax considerations alone had prompted the establishment in Denmark (paragraph 3.6.4). According to Schweizerische Bundesgericht, there was no basis for limiting the tax authorities' rejection of treaty benefits regarding the implicit antiabuse clause in the treaty.

The Swiss decision has in actual fact adopted a look-through provision corresponding to the proposal in the OECD commentary to article 1, paragraph 13. The OECD commentary only reflects a proposal for a formulation that can be applied if the contracting states should wish to include such a provision. Schweizerische Bundesgericht does not interpret an older tax treaty in light of newer comments from the OECD. The interpretation of the tax treaty should be based on what the parties have written in the treaty itself, and Schweizerische Bundesgericht has in our view gone too far in adopting the look-through provision in the Denmark-Switzerland tax treaty.<sup>74</sup>

As for the second question on domestic antiabuse rules, the OECD commentary states that tax treaty benefits should not be granted when the prime purpose of participating in a transaction or arrangement was to ensure a more favorable tax position contrary to the purpose and intention of the relevant provisions. In these circumstances, the commentary allows for a reclassification of who can be defined as a taxpayer under domestic antiabuse rules.<sup>75</sup> The question of how domestic antiabuse rules can be applied under the treaty interpretation is subject to discussion.<sup>76</sup>

Danish tax law theory is not consistent on whether rules on the determination of the rightful recipient should be considered as rules deriving from a general theory on the rightful recipient, a substance-over-form principle, or simply a matter of general interpretation of the law. There is scarcely any basis for assuming that the identification of the rightful recipient under Danish tax law requires operation in several phases. The identification of the rightful recipient takes place under Danish tax law in one run, so to speak. Danish

tax authorities will only have limited access to making adjustments under Danish tax law's principles for identification of the rightful recipient of interest income. It must be assumed that the person who is considered the rightful recipient of the interest under Danish tax law will also be considered the recipient of the interest by the Danish courts under article 11 in a treaty without a beneficial ownership clause. It cannot be expected that the Danish courts will limit tax authorities' access to adjust after the principle of the rightful recipient regarding a treaty not containing a beneficial owner clause.

## 2. Treaties With a Beneficial Ownership Clause

If a tax treaty contains a beneficial ownership clause in article 11, it is possible that the Danish tax authorities could interpret the treaty as implying that treaty benefits are denied regardless of whether the interest recipient is both the beneficial owner under article 11 and the rightful recipient under domestic tax law.

That the notion of beneficial owner has been included in a tax treaty does not change the fact that a look-through provision may be considered implicit. As mentioned above, Schweizerische Bundesgericht has in our view gone too far in its ruling by adopting a provision that has not been agreed on between the contracting states, and that a tax treaty contains a beneficial ownership concept does not change this assessment. When a beneficial ownership clause has been included, any options of denying treaty benefits have been settled conclusively.

Next, it is possible that the tax authorities may refuse to grant treaty benefits regarding interest payments if the interest recipient under a treaty is considered the beneficial owner but is not considered the rightful recipient under domestic tax law. This question will only be relevant to the extent that the notion of beneficial owner in article 11 of the treaty is to be interpreted independently of Danish tax law.

To support the right of the tax authorities to deny treaty benefits, treaties generally contain no rules on who is the rightful recipient, which must be settled by domestic law.<sup>77</sup> A decisive reason to seek autonomous interpretation of the notion of beneficial owner is that the tax treaty is interpreted and applied in the same way in both treaty states. If a treaty state is given the ability to deny treaty benefits, an unsolved double taxation problem might arise. A company in another treaty state, which under an autonomous interpretation of the treaty is considered the beneficial owner on an interest payment from Denmark, will in its country of domicile be subject to limited treaty relief based on the assumption that the Danish withholding tax under article 11

<sup>74</sup>See also Oesterhelt and Winzap, *supra* note 70, p. 461.

<sup>75</sup>See OECD commentary (2005 version) on article 1, para. 9.5 and para. 22.1.

<sup>76</sup>See Frederik Zimmer in the general report to the IFA Congress 2002, *Cahiers*, Vol. 87a, p. 60; Klaus Vogel, *Doppelbesteuerungsabkommen Kommentar*, 4th ed., 2003, Vor Art. 1, margin no. 100. The Canadian ruling in *MIL (Investments) S.A. v. The Queen*, 2006 TCC 460, assumed that treaty benefits could not be denied without the existence of specific antiabuse rules. The appeal was dismissed by the Federal Court of Appeal by ruling of June 13, 2007; see FCA 236.

<sup>77</sup>See OECD commentary (2005 version) on article 1, para. 22.1.

of the treaty is reduced or eliminated. If Denmark imposes a withholding tax on the interest payments regarding domestic principles on determination of the rightful recipient, an unresolved double taxation problem will arise.

The Danish courts — if they adopt an autonomous interpretation of the notion of beneficial owner in a tax treaty — may consider Denmark obliged to grant relief under the treaty with the state in which the beneficial owner under the treaty is resident. Consequently, Danish withholding tax will not be charged under section 2(1)(d) of the Danish Corporation Tax Act.

### III. The Interest and Royalty Directive

#### A. In General

The interest and royalty directive (Directive 2003/49/EC)<sup>78</sup> stipulates in article 1(1) that the company in another member state receiving interests or royalties must be the beneficial owner.<sup>79</sup> The recipient company must similarly be associated.<sup>80</sup> The interest and royalty directive was implemented in Danish law by Act no. 321 of March 31, 2004 (Bill no. 119), simultaneously with the introduction of a withholding tax on interest.

The directive will have no independent implications for interest payments out of Denmark because Denmark is obliged to reduce the interest taxation under section 2(1)(d) and (h) of the Danish Corporation Tax Act (which abstains completely from charging Danish withholding tax on interest).<sup>81</sup> The directive's practical implication will become apparent on payment of interest to associated companies in EU member states that do not fall under the scope of tax treaties.<sup>82</sup>

<sup>78</sup>The directive is adapted to the new member states with Directive 2004/66/EC and 2004/76/EC. Different versions of the interest and royalty directive have been presented in 1990 and 1998. The 1990 draft is commented in Danish law by Søren Næsberg, *EU-Selskabsskatteret*, 1997, p. 274. The 1998 draft has been analyzed in detail by Dennis Weber in *ECTR* 2000, p. 15, and by Søren Næsberg Jensen, *Skat Udland* 1998, p. 242.

<sup>79</sup>The notion of beneficial owner is also included in article 2 of the savings tax directive (Directive 2003/48/EC). The savings tax directive relates to interest paid to individuals and not to interest paid to associated companies.

<sup>80</sup>The term “associated company” is defined in article 3(b) of the interest and royalty directive.

<sup>81</sup>See the Danish minister of taxation's reply published in appendix 47 to question 14 (appendix 2) to Bill no. 119, parliamentary year 2003-2004.

<sup>82</sup>The Denmark-U.K. tax treaty does not apply to Guernsey, Gibraltar, Jersey, and the Isle of Man; see article 3(b) of the tax treaty. These geographical areas may prove relevant in terms of routing interest payments out of the EU. Gibraltar is covered by the geographical area of the EU; see article 299(4) in the EC Treaty. In Danish administrative practice, the parent subsidiary directive has been interpreted widely, and companies in Gibraltar have been considered to be covered by the directive; see *TJS* 1992,

(Footnote continued in next column.)

If an interest payment is made to an associate in another EU member state and the creditor company is resident in this state under a tax treaty, it should not be taken for granted that the tax treaty and the directive will lead to the same result (that is, a reduction or non-application of the Danish withholding tax). First, it cannot be ruled out that the EU's legal definition of the notion of beneficial owner differs from the notion of beneficial owner in the tax treaty. Second, to the extent that the tax treaty's notion of beneficial owner is to be interpreted autonomously, it may be possible that a reduction or nonapplication of the withholding tax will be granted under the treaty, even though the payment as a result of a domestic antiabuse provision under article 5 of the directive is not protected by the directive.

#### B. The Notion of Beneficial Owner

Under article 1(1) of the interest and royalty directive, it is a condition for applying the directive that the recipient company is the beneficial owner of the interest. According to the beneficial owner definition in article 1(4), a company can only be considered the beneficial owner of the interest if the company receives the interest for its own use and not as an intermediary, including as an agent, proxy, or authorized signatory for another person.<sup>83</sup>

The directive's notion of beneficial owner is interpreted conclusively by the ECJ, and it is to be expected that the ECJ will interpret the notion on an EU law basis.<sup>84</sup> The directive's definition of the notion of beneficial owner is, however, not exhaustive, and it is reasonable to assume that the ECJ in its interpretation will seek guidance in the delimitation of the notion of beneficial ownership in the OECD model treaty.<sup>85</sup> That the notion of beneficial owner is not clearly defined in the OECD model treaty obviously limits the implication thereof.

On determining the directive's notion of beneficial owner, the ECJ could be expected to seek guidance on how the member states have interpreted the notion in connection with the implementation of the directive.<sup>86</sup> As part of an examination of the implementation of

441 SKD. This practice is criticized by Michael Kirkegaard Nielsen et al., *Skat Udland* 2005, 43, who states that Gibraltar is not a part of the United Kingdom and that the appendix to the directive does not cover companies or tax in Gibraltar.

<sup>83</sup>Article 1(5) contains a definition of the notion of beneficial owner, which relates to the situation when a permanent establishment receives the interest.

<sup>84</sup>See Klaus Eicker and Fabio Arami, *ECTR* 2004, p. 142. See Luc Hinnekens, *BIFD* 2000, p. 324, on the various objectives addressed by the ECJ and the tax treaties. See also Matthias Dahlberg, *Internationell beskattning*, 2005, p. 294.

<sup>85</sup>See Brent Springael, *DFI* 2004, p. 282.

<sup>86</sup>See Joanna Wheeler, *Cahiers*, Vol. 92b, p. 24.

the directive, IBFD has summarized the question on the member states' implementation of the directive's beneficial owner clause as follows:

Member States usually require the recipient company to be the beneficial owner of income received. In many instances, however, the definition of the beneficial owner has been transposed with deviations, has not been incorporated into the law or has not been incorporated because the existing domestic law concepts apply.<sup>87</sup>

It is apparent that even though the ECJ decides to attach importance to the member states' implementation of the directive in the interpretation, there is only modest guidance to obtain.

Finally, it can be considered whether the ECJ decides to interpret the notion of beneficial owner in the light of the abuse provision of article 5, and its practice on abuse of law.

The definition in the directive attaches importance to the payments being for personal use of the receiving company, which should not be an intermediary, including an agent, proxy, or authorized signatory for another person. This tends to lead to an interpretation, according to which it is only in purely artificial transactions in which an inserted intermediary does not benefit financially from the interest payment that the interest recipient is not to be considered the beneficial owner.<sup>88</sup> In this case there will rarely be a basis for denying a foreign group company in an EU state that receives interest from a Danish company status as the beneficial owner under the directive, even though the company has borrowed a corresponding amount with another group company outside the EU when interest rates and terms for the two loans are not identical, and no special terms have been agreed.<sup>89</sup>

Some clarification regarding the notion of beneficial ownership from an EU law perspective might come in a new case that has been lodged before the ECJ.<sup>90</sup> The ECJ has been presented with the following question submitted for a preliminary ruling:

Is the Law of 28 December 1992, which amended the wording of Art. 202 of the 1992 Code of Taxation on Income by referring to Directive 90/435/EEC (1) and required that the beneficial owner of dividends had a holding of

capital in the Company which distributed such dividend, in as much as that Law does not explicitly specify that the holding must be as full owner and therefore implicitly permits the interpretation made by the respondent, that the mere holding of a right of usufruct of shareholdings in the capital carries the right to tax exemption on such dividends, compatible with the provisions of that Directive concerning holdings in capital, and in particular with its art. 3, 4, and 5?

For the time being, the definition of the notion of beneficial owner in the interest and royalty directive is not clear. The analysis below will examine what importance may be attached to the abuse provision in article 5 of the interest and royalty directive and the ECJ's practice on abuse of law in the delimitation of the directive's notion of beneficial clause.

### C. Article 5

Article 5 of the interest and royalty directive provides the possibility of introducing fraud and abuse rules in national and international law. According to article 5(1), the directive does not exclude the application of national or agreement-based provisions required for the prevention of fraud or abuse. For transactions for which the principal motive (or one of the principal motives) is tax evasion, tax avoidance, or abuse, the member states may, under article 5(2), withdraw the benefits of this directive or refuse to apply this directive.

Article 5 of the directive is subject to an EU law interpretation. The ECJ determines whether it is in compliance with the directive if a member state according to domestic legislation has refused the benefits of the directive. It must be assumed that the ECJ will interpret the provision in accordance with its general practice on fraud and abuse. It must also be assumed that some use of conduit companies will be considered acts of fraud or abuse.<sup>91</sup> Article 5 is, however, to be interpreted in compliance with the proportionality principle, and the tax authorities must subject each particular case to a general examination, which must be open to judicial review.<sup>92</sup>

When article 1(4) of the directive, combined with subarticle 1 on the beneficial owner clause, can result in interest payments not being covered by the directive, article 5 presupposes the existence of domestic authority to deny directive benefits. The ECJ has stated in *Kofoed* (regarding the merger directive), a member state

<sup>87</sup> See table 4, p. 18, *Survey on the Implementation of the EC Interest and Royalty Directive*. The individual country surveys contain specific reproductions of the examinations carried out.

<sup>88</sup> See Brent Springael, *DFI* 2004, p. 282; Marcello Distaso and Raffaele Russo, *ET* 2004, p. 143.

<sup>89</sup> Dennis Weber has concluded, "I doubt whether the beneficial owner requirement can obstruct the use of conduit companies." See *EC Tax Review* 2000, p. 22.

<sup>90</sup> See case C-48/07, *Les Vergers du Vieux Tauvers SA*.

<sup>91</sup> See Klaus Eicker and Fabio Aramini, *ECTR* 2004, p. 142, who note that conduit reflects an abusive transaction.

<sup>92</sup> See case C-27/95, *Leur Bloem*, para. 43, regarding article 11 of the merger directive (Directive 90/434/EC). A provision corresponding to article 5 of the interest and royalty directive is found in article 1(2) of the parent-subsidiary directive.

is obliged to adopt — within the framework of its national legal system — all the measures necessary to ensure that the directive is fully effective, in accordance with the objective that it pursues. However, the principle of legal security precludes EU directives from creating obligations for citizens by themselves.<sup>93</sup>

Therefore, it cannot be assumed that the abuse provision in article 5 can be adopted in article 1(4) as to the definition of the notion of beneficial owner. That the directive, contrary to the tax treaties, contains an actual abuse provision indicates that the directive's notion of beneficial owner in article 1(4) is interpreted narrowly according to the wording of the provision.<sup>94</sup> Legal security considerations prevent that a directive in itself implies obligations for taxpayers, and article 5 of the directive grants member states the right to uphold the consideration to avoid abuse through national anti-avoidance rules.<sup>95</sup> Finally, it would create a correlation to the interpretation of the parent-subsidiary directive if the consideration to avoiding abuse is upheld by the abuse provision in article 5 of the interest and royalty directive and not by the directive's beneficial owner clause, as the parent-subsidiary directive does not contain a notion of beneficial owner as supplement to the abuse provision in article 1(2) of that directive.

The abuse provision in article 5 can result in directive benefits being refused, but it is a condition that domestic law contains an authority thereto.<sup>96</sup> Such a domestic law authority does not have to be specified in a domestic statutory provision, but can be included in general principles prohibiting abuse of rights or other provisions on tax evasion or tax avoidance.<sup>97</sup> It must

<sup>93</sup> See case C-321/05, *Kofoed*, para. 41.

<sup>94</sup> This may lead to the notion of beneficial owner in the directive being interpreted more narrowly than the notion of beneficial owner in the tax treaty; the OECD commentary (as of the 2003 version) to article 11 states that the notion of beneficial owner is not applied in a narrow technical meaning, but should be seen in correlation with and in the light of the treaties' intention and purpose, including avoiding double taxation and preventing tax evasion and tax avoidance.

<sup>95</sup> See case C-321/05, *Kofoed*, para. 37, in which the ECJ establishes that the application of the similar abuse provision in article 11 in the merger directive presupposes authority in domestic law.

<sup>96</sup> Article 5 further states that the provision does not exclude application of treaty-based provisions designed to combat fraud or abuse. According to Danish law, a tax treaty does not in itself provide authority to tax; see Niels Winther-Sørensen, "The So-Called Golden Rule," in: Jan Pedersen et al. (eds.), *Tax Law 3*, 4th ed. p. 37.

<sup>97</sup> See case C-321/05, *Kofoed*, para. 43. In its comparative examination of the implementation of the interest and royalty directive, the IBFD has summarized the member states' implementation of article 5:

All Member States apply general anti-abuse measures under domestic law to deny the relief under the Directive in

(Footnote continued in next column.)

also be assumed that article 5 does not comprise actual written abuse rules only, but also includes avoidance or abuse clauses based on case law.<sup>98</sup> In Danish law, the case law regarding the rightful recipient and a specific substance-over-form assessment can form the basis for the Danish tax authorities' refusal to use the directive.

#### D. ECJ Case Law

Recently the ECJ has decided a number of tax law cases concerning the abuse of EU law.<sup>99</sup> The ECJ has held that national legislation that limits the freedom of establishment may be justified when it specifically targets purely artificial arrangements with the object of circumventing the relevant member state's legislation.<sup>100</sup>

It must be considered whether this practice can be assumed to have any significance on the interpretation of the interest and royalty directive and, if so, whether this has relevance on the interpretation of the notion of beneficial owner in article 1(4) or the interpretation of the abuse provision in article 5.

Concerning limiting the freedom of establishment, the ECJ made the following statement in *Cadbury Schweppes* regarding the U.K. controlled foreign corporation rules:

It follows that, in order for a restriction on the freedom of establishment to be justified on the ground of prevention of abusive practices, the specific objective of such a restriction must be to prevent conduct involving the creation of wholly artificial arrangements which do not reflect economic reality, with a view to escaping the tax normally due on the profits generated by activities carried out on national territory.<sup>101</sup>

The ECJ further stated that a restriction of the freedom of establishment cannot be justified when, despite the existence of tax motives, the incorporation of a CFC reflects economic reality. That incorporation must correspond with an actual establishment intended to carry on genuine economic activities in the host member state.<sup>102</sup>

cases of fraud and abuse. In many instances, specific measures for the purpose of the directive have been introduced. . . . Only Austria and Germany have introduced specific measures that follow closely.

<sup>98</sup>In relation to the parallel provision in article 1(2) of the parent-subsidiary directive, see Otmar Thömmes, *EC Corporate Tax Law*, para. 19 of article 1; Fred De Hosson, *Intertax* 1990, p. 427; Søren Næsborg Jensen, *EU-Selskabsskatteret*, 1997, p. 311.

<sup>99</sup>Regarding the doctrine of abuse of the ECJ, see Karsten Engsig Sørensen, *Common Market Law Review*, 2006, p. 423.

<sup>100</sup> See, e.g., case C-196/04, *Cadbury Schweppes*, para. 51.

<sup>101</sup> *Id.* at para. 55.

<sup>102</sup> *Id.* at para. 65.

The presence of an economic reality in relation to the CFC rules had to be determined on the basis of objective circumstances, which can be tested by a third party (for example, the degree of the CFC company's physical existence as to premises, staff, and equipment).<sup>103</sup> In this regard, the ECJ referred to letterbox companies as examples of artificial arrangements.

The VAT decision in the *Halifax* case has a special interest regarding conduit companies; the case concerned a VAT-exempt bank (with 5 percent VAT deduction) that let its relevant transactions pass a fully taxable subsidiary to obtain full VAT deduction. The ECJ concluded that a VAT refund could not be allowed under the Sixth VAT Directive when the underlying transaction constitutes an abusive practice. The finding of an abusive practice first requires that the transactions concerned, despite formal application of the conditions laid down by the relevant provisions of the sixth directive and of national legislation transposing it, result in the accrual of a tax advantage, the grant of which would be contrary to the purpose of those provisions. Second, it must also be apparent from a number of objective factors that the essential aim of the transactions concerned is to obtain a tax advantage.<sup>104</sup> Tax authorities in several member states have interpreted *Halifax* widely, implying that importance has been attached to the decision in terms of direct taxes and conduit companies.<sup>105</sup>

It must be assumed that the ECJ's practice on abuse should be emphasized in the interpretation of the general abuse provision in article 5 of the directive, as it seems obvious to consider this provision to reflect the ordinary EU law principle on prohibition against abuse of rights.<sup>106</sup> It cannot be assumed that the abuse provision in article 5 is to be adopted in article 1(4) on the definition of beneficial owner; moreover, it cannot be assumed that the ECJ practice on abuse is to be adopted at the delimitation of the notion of beneficial owner in article 1(4).

It is not in itself an indication of fraud or abuse that a company has been established in another member

state.<sup>107</sup> This also applies when a company outside the EU has established a subsidiary within the EU, which has granted the loan to a Danish subsidiary. Only if the specific circumstances show that the case concerns an artificial arrangement with the main objective of obtaining a tax benefit can it be considered fraud or abuse.

The ECJ has emphasized whether there was any substance in the company's country of domicile, and it is possible that this fact will play a greater role for the ECJ's assessment than in the Danish courts' assessment of who may be considered the rightful recipient. No compliance necessarily exists between the interpretations in article 5 of the interest and royalty directive, which the ECJ lays down in light of its practice on abuse of law, and the principle in Danish tax law on rightful recipient.

## E. Conclusion

The interest and royalty directive implies that interest payments from a Danish subsidiary to an associated company in another EU member state will not be subject to withholding tax if the interest recipient is the beneficial owner. The directive's definition of beneficial owner is not yet clarified. The wording and correlation with the abuse provision in article 5 probably results in the notion of beneficial owner in article 1(4) being interpreted restrictively, implying that only in purely artificial transactions when an inserted intermediary does not gain any economic benefit from the interest payment, such an intermediary is not to be considered the beneficial owner.

The abuse provision in article 5 of the directive must be considered a reflection of the ordinary EU law principle on abuse of rights and is to be interpreted accordingly. The provision can result in the directive's benefits being refused if authority exists in domestic law. It is, however, a condition that the refusal to grant the directive's benefits is in compliance with article 5 under the interpretation of this provision by the ECJ.

<sup>103</sup>*Id.* at para. 67.

<sup>104</sup>See case C-255/02, *Halifax*, para. 85. The outcome of the case is in line with established case law, according to which the EU law cannot be relied on in case of abuse or fraud; see, e.g., case C-367/96, *Kefalas*, para. 20; case C-373/97, *Diamantis*, para. 33; and case C-32/03, *Fini H*, para. 32. In *Halifax*, however, the Court found it completely irrelevant for the interpretation of the Sixth VAT Directive whether the main objective of the transaction was to obtain tax benefits; see para. 59 of the case.

<sup>105</sup>See Sheppard, *supra* note 51; for Italian law, see Rossi, *supra* note 20; and for French law, see Laurent Leclercq, *Bulletin* 2007, p. 235.

<sup>106</sup>See case C-321/05, *Kofoed*, para. 38, on the abuse provision in article 11 of the merger directive.

<sup>107</sup>See case C-347/04, *Rewe Zentralfinanz*, para. 52. The case concerned the German rules on deduction for write-down of shareholdings, which were not applicable to shareholdings in foreign subsidiaries. The ECJ found this to constitute a restriction of the freedom of establishment in article 43 of the EC Treaty. Of particular interest is that the case concerned a group in which the foreign subsidiaries were owned by a Dutch holding company. The ECJ noted in paragraph 52 that the formation of a company outside a member state does not, of itself, imply the existence of tax avoidance, since the company in question is subject to the tax legislation of the state in which it is established. It can be argued that a conduit company will be subject to the tax law in the state of establishment and thus that the establishment of such a company in another member state does not imply abuse.

## IV. Danish Tax Law

### A. Withholding Tax on Interest

Withholding tax was introduced in Denmark in 2004 regarding interest payments to related parties.<sup>108</sup> Foreign related companies are liable to Danish withholding tax on interest payments paid from a Danish company. It is a prerequisite that the interest payment is connected to debt that has been qualified as controlled debt within the meaning of section 3(B) of the Danish Tax Control Act. A similar provision was introduced regarding capital gains on claims, arising from debt redeemed with a premium agreed in advance, which under domestic Danish tax law is characterized as capital gains.<sup>109</sup>

The withholding tax is not triggered by interest payments if one of the following exemptions applies:<sup>110</sup>

- if the interest is effectively connected to a permanent establishment in Denmark;
- if the taxation is reduced or eliminated according to the interest and royalty directive or a tax treaty with the state of residence of the recipient company;
- if the receiving company is controlled by a Danish company (whereby the Danish CFC rules may apply);
- if the recipient company is controlled by a company resident in a tax treaty state (the recipient company may be subject to CFC taxation of the interest in the state of residence), if the conditions are met according to domestic CFC legislation of the state of residence of the company in a tax treaty state; and
- if the recipient company proves that the foreign corporate taxation of the interest payments received is at least three-fourths of the Danish corporate tax (currently 25 percent) and that the recipient company does not pay on the interests to foreign companies, which are subject to company taxation of the received interest that is less than three-fourths of the Danish corporate taxation.

In practice, a direct loan from a related company in a non-EU/non-tax treaty state to a Danish related company will trigger a Danish withholding tax of 30 percent of the interests paid or capital gains realized.

<sup>108</sup>See section 2, para. 1(d), CTA, as enacted by Act no. 221 dated Mar. 31, 2004 (Bill no. 119).

<sup>109</sup>See section 2, para. 1(h), CTA.

<sup>110</sup>See CTA section 2, para. 1(d) and (h). The exemptions apply as well to capital gains on claims, arising from debt redeemed with a premium agreed in advance. The terms in section 2, para. 1(d), paras. 5-7 CTA have been rephrased by Act no. 540 of June 6, 2007 (Bill no. 213).

This is not the case with payments to related companies resident in EU or tax treaty states.

Also, the rules on withholding tax on interest take precedent over the thin cap rules in section 11 CTA. Thus, both rules cannot apply at the same time. However, the recently introduced interest deductibility limitation legislation under the so-called asset test and the earnings before interest and tax test may apply simultaneously with the withholding tax.<sup>111</sup>

The analysis carried out in this article is concentrated on the exceptions in nos. 2 and 3, according to which the withholding tax on interest does not apply if the taxation is to be reduced or eliminated according to a tax treaty or the interest and royalty directive.

It may seem unnecessary to state that Denmark should fulfill its obligations under international law. However, the provision is to be understood as implying that the withholding tax on interest is abolished even if the withholding tax is only reduced under a tax treaty.<sup>112</sup>

The notion of beneficial ownership has not been clarified in the preparatory work to the bill introducing Danish withholding tax on interest. Also, no directly applicable case law exists on the issue.

The company on whose behalf payment of interest or redemption of debt is made is obliged to withhold tax.<sup>113</sup> Under section 66B(1) of the Danish Withholding Tax Act, payment of withholding tax falls due on payment or crediting of interest. The party making the payment or the crediting will, concurrently with the payment of the withholding tax, provide information thereon in the form of a statement.<sup>114</sup>

The paying company will assess whether the requirements for not withholding interest tax have been fulfilled. If the receiving company is resident in the EU or a treaty country, interest tax is not to be withheld under the directions of the aforementioned Form 06.026 item A. The directions make no reservations if the recipient company is not the beneficial owner.

The Danish courts, despite the general opinion in the international tax law theory and practice, opinion will be inclined to interpret the notion of beneficial owner in the tax treaties with reference to Danish tax law. Moreover, the application of the abuse provision in article 5 of the interest and royalty directive is subject to the condition that domestic authority may refuse the granting of the directive benefits.

<sup>111</sup>See sections 11B and 11C, CTA.

<sup>112</sup>See Ann-Christin Holberg and Anne Katrine Føgh, *Skat Udland* 2004, p. 208.

<sup>113</sup>See section 65 D of the Danish Withholding Tax Act.

<sup>114</sup>See Form 06.026 regarding interest withholding tax.

The sections below examine to what extent Danish tax law contains authority to adjust who can be considered the rightful recipient of interest payments on claims. A number of statements made by Minister of Taxation Kristian Jensen in recent years form the basis for the analysis, including how to obtain possible interpretations from case law within neighboring areas.

## B. Minister of Taxation's Statements

Jensen has on several occasions commented on the opportunity to deny treaty and directive benefits regarding the Danish withholding tax. The comments have been given to the Danish parliament's tax committee in connection with the passing of bill nos. 119 from 2004, 116 from 2006, and 213 from 2007.

The minister's reasoning has not been entirely consistent in the three answers. In his first answer in 2004, he stated that the tax authorities on the basis of a substance-over-form assessment may conclude that the beneficial owner of the interest is the financial company in the low-tax country.<sup>115</sup> In this respect, Jensen referred to article 5(2) of the interest and royalty directive and the OECD commentary to article 1 as the legal basis for the statement. Both of these provisions must, however, be assumed to presuppose domestic authority.

A later reply by Jensen in 2006 indicates that the minister does not sharply distinguish between the term "beneficial owner" and the term "rightful recipient."<sup>116</sup> The notion of rightful recipient cannot be found in the tax treaties or in the interest and royalty directive, and the notion is normally used to indicate for whom the income should be reported in accordance with Danish tax law.

In his comments from 2006, the minister of taxation seems to presuppose that, under the rightful recipient principle, domestic authority exists in Danish tax law to consider another company than the formal interest recipient as the recipient of interest if it is in accordance with a specific tax treaty or the interest and royalty directive. The notion of rightful recipient must be considered equal to the notion of beneficial ownership. The statement that a conduit company may not be considered the rightful recipient or beneficial owner must be considered far-reaching even if the minister fails to express what is understood by a conduit company other than a reference to what is indicated in the OECD commentary.

<sup>115</sup>See the minister of taxation's reply to the parliament's tax committee, parliamentary year 2003-2004, Bill no. 199, enclosure 21 as answer to enclosure 16. See Ann-Christin Holberg and Anne Katrine Føgh, *Skat Udland* 2004, p. 208; Jan Guldmand Hansen and Nikolaj Vinther, *SpO* 2004, p. 237.

<sup>116</sup>See the minister of taxation's reply to the parliament's tax committee, parliamentary year 2005-2006, Bill no. 116, appendix 9.

Even more far-reaching are Jensen's comments in 2007 regarding inbound dividends under section 13(1)(ii) of the CTA.<sup>117</sup>

It is noted that incoming dividends will not be tax-exempt even if the dividends are paid by a company within the EU/EEA or a country which has concluded a tax treaty with Denmark if such company is a conduit company between the Danish parent and the subsidiary resident outside the EU/EEA which has not concluded a tax treaty with Denmark.

In the OECD commentary, the notion of conduit company is used as a term for identifying the problems arising when such companies are interposed.<sup>118</sup> The OECD commentary suggests provisions that include some cases of conduit companies. According to the OECD commentary, conduit companies will also include cases when a tax adjustment is not made.

In the comments in 2007, however, Jensen uses the notion "conduit company as a legal concept," expressing that the company in question should not be considered recipient of the interest. The minister notes that tax adjustment may take place to a further extent than stated in the OECD commentary.

In a reply to the parliament's tax committee in response to a critical question from the FSR (the Danish Association of State Authorized Public Accountants), Jensen has retreated slightly from his earlier comment, even if he seems to equate whether a company can be considered a conduit company with whether the company may be denied relief under the tax treaty.<sup>119</sup>

Since the minister of taxation's comments are based on general abuse considerations, it is difficult to see whether the notion of beneficial ownership in the tax treaty in his view should be interpreted autonomously. In a comment made on November 6, 2006, Jensen argued that the notion of rightful recipient must be considered equivalent to the notion of beneficial owner in the tax treaties, but in other comments he paid particular attention to the OECD commentary to article 1 and general abuse considerations.

The minister's comments should probably be understood in the way that the tax treaties and the interest and royalty directive provide the required authority to

<sup>117</sup>See the minister of taxation's comments to Bill no. 213 of Apr. 18, 2007, special comments to section 1(vi). Although the comments concern dividends, the comments are similarly relevant to interest.

<sup>118</sup>See OECD commentary on article 1, para. 13, and article 10, para. 12.1.

<sup>119</sup>See the minister of taxation's reply to the parliament's tax committee, Bill no. 213, parliamentary year 2006-2007, enclosure 26.

deny reduction or elimination of the Danish withholding tax and that the minister has not found it significant to emphasize whether this authority exists in abuse considerations or in an interpretation of the notion of beneficial owner. Furthermore, Jensen's comments should be understood to indicate that the required authority does exist in Danish tax law.

Some of his comments, particularly those in 2007, seem to express a rather extensive access to making adjustments for the tax authorities. On the basis of case law, the following section looks at whether sufficient support exists for these comments in domestic Danish tax law.

### C. 'Rightful Recipient' Case Law

The notion of beneficial owner comes from common law traditions, and it is not a familiar concept in Danish tax law. In Danish tax law the rightful recipient notion is applied in relation to interest income as a term for which the taxpayer should be considered as having earned the interest in a fiscal context.<sup>120</sup>

The cases that give rise to discussions are typically characterized by a financing company (Luxco Sarl. in the example from Section I) having financed its lending to the Danish company by raising a loan with the group company domiciled in a non-EU/non-tax treaty state (Caymanco Ltd.). If the group company (Caymanco Ltd.) is considered the rightful recipient of the interest income according to a Danish tax law assessment, this could lead to the Danish tax authorities and courts establishing that the tax treaty between Denmark and the home country of the intermediary financing company (Luxembourg) does not apply, since the intermediary financing company (Luxco Sarl.) is not the beneficial owner according to the treaty. It must be assumed that the Danish courts to some extent will tend to interpret the notion of beneficial owner in accordance with Danish tax law.

The Danish tax law determination of the rightful recipient is also significant in relation to the interest and royalty directive, which in the antiabuse provision in article 5 provides for a member state in some circumstances having the right to deny granting of benefits of the directive if domestic authority exists thereto.

#### 1. The Main Rule

According to Danish tax law, ownership is attributed to one person. Concepts corresponding to the notion of beneficial owner are unfamiliar under Danish law, and there is no distinction between formal (legal) and financial ownership in domestic Danish tax law.

<sup>120</sup>Only the Danish monograph on the rightful recipient matters: Henrik Dam, *Rette indkomstmodtager — allokering og fiksering*, 2005, in his U.K. summary, p. 794, applies the English term "rightful recipient."

Also, it is a general basis of Danish tax law that interest is taxed with the person having the ownership of the claim in a private law context.<sup>121</sup> The fact that the group could have decided to let the parent company (Caymanco Ltd.), domiciled in a non-EU country, lend the amount to the Danish company (indicating that Danish withholding tax would be imposed on interest payments) is not sufficient to consider this company as the rightful recipient when the intermediate EU subsidiary (Luxco Sarl.) has granted the loan to the Danish company and in a civil law context has the ownership of the claim (as lender).

## According to Danish tax law, ownership is attributed to one person.

If a different person than the owner of the claim is to be considered the rightful recipient of the interest, case law requires a special reason. The central question is then what is required for the Danish tax authorities to be entitled to consider Caymanco Ltd. to be the rightful recipient of the interest in a tax law context.

Danish tax law has not specifically considered a similar situation when a foreign group enterprise that is a creditor to a Danish company has borrowed the funds from another foreign group enterprise.

Case law is analyzed below in related areas when a special reason for not considering the formal recipient of interest income the rightful recipient for tax purposes has been present.

#### 2. Interposed Invoice Companies

In case law regarding interposed invoice companies, several rulings show that the courts have not recognized that profits are transferred to foreign letterbox companies through intercompany transactions.<sup>122</sup> These cases have been characterized by the interposed invoice companies not serving any purpose other than minimizing the total taxable income and not managing activities other than the interposed invoicing itself. The companies were characterized by not having their own premises, employees, or actual business activities. The interposed invoices were overruled in terms of tax law as sham. Furthermore, the cases led to criminal sanctions.

<sup>121</sup>See Henrik Dam, *Rette indkomstmodtager — allokering og fiksering*, 2005, p. 335 and 412. The author concludes that return on capital (including interest) must ordinarily be allocated to the tax subject with ownership of the underlying property.

<sup>122</sup>See *UfR* 1982, 703 Ø; *UfR* 1983, 845 Ø; *TfS* 1989, 150 Ø; and *TfS* 1992, 395 H.

On the basis of the above case law, a requirement could be considered as to a qualified physical presence in the country in which the creditor company is resident, such that Luxco Sarl. must not only be resident in Luxembourg, but that requirements are set as to, for example, premises, business activities, or employees.

It seems obvious to assume that such physical presence will be a factor to which importance can be attached in a situation with a loan from a company like Luxco Sarl. However, it will probably be too far-reaching to transfer case law concerning a group company, which distributes goods, to a company like Luxco Sarl., which performs services to the Danish company.

### 3. Taxation of Persons Other Than the Formal Creditor

In special circumstances, it must be assumed that the tax authorities have access to allocating interest income to a person other than the formal creditor. *TfS* 1990, 293 H is a central example. In this case, a taxpayer had granted an interest-free loan to his late father's former partner. The father's former partner had acquired bonds for the proceeds of the loan, which according to agreement with the taxpayer should be provided as security for the interest-free loan, and which were not to be sold without prior permission. The Danish Supreme Court stated that the arrangement should be seen as a whole and that the bond interest yield must be considered current income randomly transferred from the taxpayer to the father's former partner. The Supreme Court found that the taxpayer was liable for tax on the received interest yield. The ruling should be interpreted as the Supreme Court finding that the taxpayer was the rightful recipient for tax purposes of bond interest yield.

It is possible that foreign conduit companies may be disqualified from their status as recipients of interest income on the basis of a comparable reasoning from a Danish tax law point of view.

In *TfS* 1990, 293 H, the intention was to transfer ongoing payments to the father's former partner. The limited access to deductibility for ongoing payments was circumvented. This aspect is generally not included in international group financing. The purpose of letting a company in an EU or tax treaty state grant a loan to the Danish company is to avoid the Danish withholding tax, which will be imposed if a loan is granted from a company in a non-EU or non-tax treaty state instead.

The decision shows that the Supreme Court does not abstain from making an overall assessment when special terms and conditions have been agreed on (in the ruling, interest exemption and the agreement about not selling the bonds), so as to tax a person other than the formal creditor of the interest income. On this basis, one can assume that the Supreme Court, if special terms have been agreed on indicating that the intention was to avoid Danish withholding tax, in an overall as-

essment of the company will consider a company equal to the rightful recipient.

In practice, however, significant differences will often exist for the situation in *TfS* 1990, 293 H, and the situations arising in connection with international group financing. In *TfS* 1990, 293 H, the lender ensured himself rights of the bonds because these were provided as security for the interest-free loan and were not to be sold without prior permission. In this area too, the typical situations concerning international group financing cannot be compared.

### 4. The Substance-Over-Form Approach

In several cases on sale and leaseback arrangements carried out to obtain considerable tax amortization to Danish individuals, the courts have established that for tax purposes the Danish taxpayers have not been owners of the acquired asset.<sup>123</sup>

According to Danish tax law, the person who is considered the owner of the claim for tax purposes is considered the rightful recipient of the interest income. If it is not the company in the EU or tax treaty state that for tax purposes is considered the owner of the claim on the Danish company, the company in question also cannot be considered the rightful recipient of the interest income.

**The person who is considered the owner of the claim for tax purposes is considered the rightful recipient of the interest income.**

The principle has been that the tax authorities in some cases are entitled to disregard a formal ownership. This principle may in special cases be transferred to the tax ownership of claims. Such a principle could, for example, be applied if the loan from Caymanco Ltd. to Luxco Sarl. has been granted on such terms, that Luxco Sarl. does not actually risk deficit/loss, or have a profit opportunity and is in fact prevented from having the claims on the Danish companies at its disposal.

### 5. Minister of Taxation's Statements

The OECD commentary to the model treaty uses the notion of conduit company in a broad sense as a

<sup>123</sup>See the Supreme Court's decisions in *TfS* 2000, 374 H (concerning operating equipment), and *TfS* 2000, 1011 H (concerning airplanes).

term for cases when it may deny treaty relief by introducing special rules. However, the Danish minister of taxation has used the notion of conduit company as a term for a company that may be denied treaty protection regarding interest or dividends. The minister has expressed that the possibility of denying protection under a tax treaty exists to a far wider extent than indicated in the OECD commentary.

It is possible that the minister of taxation in his comments has extended the tax authorities' possibility of making adjustments on the basis of the rightful recipient notion. The courts should not be influenced by the minister's comments when assessing whether a company like Luxco Sarl. or Caymanco Ltd. should be considered the rightful recipient.

Also, a general principle in Danish tax law is that interest is taxed with the person having the ownership of the claim from a private law perspective. If the rightful recipient of the interest should be considered a different person than the owner of the claim, case law requires a special reason. When assessing whether a concrete situation gives grounds for derogating from the clear statement that interest is taxed with the person who has ownership of the claim from a private law perspective, it seems reasonable to assume from the Supreme Court's practice in the examined related areas that one criterion is not decisive, but that an overall assessment will be made on the existing facts and circumstances. Importance can be attached to the following criteria in this assessment (based on the example in Section I):<sup>124</sup>

- **Physical presence.** If Luxco Sarl. has not been physically present in the form of premises, business activity, or staff in its domicile country, this, viewed separately, speaks against considering the company as the rightful recipient of interest on the company's loan to DK A/S (and vice versa). However, the criterion in itself can hardly be sufficient to disqualify Luxco Sarl. as the rightful recipient, since physical presence is not required in connection with lending.
- **Other assets and activities.** If Luxco Sarl. has other assets and activities, this will speak in favor of considering Luxco Sarl. as the rightful recipient of the interest from DK A/S. In practice, a financing company in the EU or a tax treaty state is often responsible for the financing of subsidiaries in a number of countries. It could also be a holding company in the EU or a tax treaty state owning the shares in subsidiaries in various countries and also granting loans to them. Here a

sound business reason can be presented for Luxco Sarl. being the company that granted the loan to DK A/S. Also, that Luxco Sarl. has a number of activities leads to the situation that the risk Caymanco Ltd. runs becomes indirect if DK A/S fails to perform with Luxco Sarl. However, it tends toward invalidating Luxco Sarl.'s status as the rightful recipient if Luxco Sarl.'s sole function is to grant loans to DK A/S.

- **Caymanco Ltd. has formally assumed the risk of DK A/S's inability to pay.** In a lending situation, the lender (Luxco Sarl.) assumes the risk of lacking repayment. If nonrecourse terms have been agreed between Luxco Sarl. and Caymanco Ltd. (so that Luxco Sarl. is not to pay back its loan with Caymanco Ltd. to the extent that DK A/S fails to perform), Caymanco Ltd. will have assumed a risk that normally lies with the lender. This matter will strongly indicate that Caymanco Ltd. rather than Luxco Sarl. is the rightful recipient of the interest paid by DK A/S.
- **Caymanco Ltd. has not formally, but in actual fact has assumed the risk of DK A/S's inability to pay,** for example, in an arrangement with back-to-back loans. Even if nonrecourse terms have not been agreed on between Luxco Sarl. and Caymanco Ltd., it may be that Caymanco Ltd. actually has a risk comparable to that of Luxco Sarl. For example, if Luxco Sarl.'s only actual asset (besides the shares in DK A/S) is the claim on DK A/S, the Danish company's nonperformance of its obligations with Luxco Sarl. could also lead to Luxco Sarl. not fulfilling its obligations with Caymanco Ltd. This situation is different from the nonrecourse situation in that Luxco Sarl. is normally not discharged from its obligations as a result of the nonperformance on the part of DK A/S. Still, from an economic point of view, it could be asserted that Caymanco Ltd. is liable for the loan to DK A/S, which will be included in the overall assessment in considering Caymanco Ltd. rather than Luxco Sarl. as the rightful recipient of interest from DK A/S.
- **The claim on DK A/S has been provided as security** for Luxco Sarl.'s loan with Caymanco Ltd. It is quite common to provide security for loans. That Luxco Sarl. has provided its claim on DK A/S as security for its loan with Caymanco Ltd. does not change the fact that Luxco Sarl. is the creditor. However, the collateral can be included as one factor that can tend towards Caymanco Ltd. actually being liable for the loan with DK A/S.
- **The right to have the claim on DK A/S at disposal.** If Luxco Sarl. has maintained its right to have the claim on DK A/S at its disposal, for example, in connection with assets sold or charged

<sup>124</sup>See Bernstein, *supra* note 20, recommending that conduit companies should have substance. See Peter M. Daub, *Cahiers*, Vol. 92b, 2007, p. 683, for an overview of the criteria developed in U.S. case law since the 1970s.

to a third party, this speaks in favor of considering Luxco Sarl. as the rightful recipient of interest.

- The right to **have the yield of the claim on DK A/S at disposal**. If Luxco Sarl.'s access to having the return of the claim on DK A/S at its disposal has been reduced, this factor will speak in favor of considering Caymanco Ltd. and not Luxco Sarl. as the rightful recipient of the interest.
- **Terms of the loan** to and from Luxco Sarl. In the case of great consistency in terms of size, interest rates, or repayment terms for the loan that Luxco Sarl. has granted to DK A/S and the loan that Caymanco Ltd. has granted to Luxco Sarl., this factor would suggest that Caymanco Ltd. can be considered as the rightful recipient. In practice, a split of, say, one-eighth is often agreed to be the interest rate for the two loans, as the tax authorities in other countries seem to attach great importance to this element. However, it cannot be assumed that such a split ensures that Luxco Sarl. can be considered as the rightful recipient of interest at all times. This is only one factor among several.
- **Arm's-length terms and documentation**. If the loan agreements have been concluded at arm's-length terms, prices and terms generally must be adjusted according to the transfer pricing legislation. In severe cases, nonobservance of the arm's-length terms will probably be considered a factor supporting an adjustment of the rightful recipient. However, the existence of documentation and bookkeeping can help recognize the recipient as the rightful recipient.
- Does Luxco Sarl. have **sufficient equity**? Whether the conduit company was sufficiently capitalized to perform the activity in question has made a difference in other countries. The criterion can be important in that an undercapitalized company risks not being considered as the rightful recipient.
- The **convergence in terms of time** between the establishment of the loans and the cash flows can probably influence the matter, in that a very short period between the establishment of the loans and the actual cash flows may help disqualify Luxco Sarl. as the rightful recipient.
- **More interposed companies**. In the example in Section I, it is assumed that there is only one company in the EU or tax treaty state (Luxco Sarl.) partly having interest expenses payable to Caymanco Ltd. and partly having interest income from DK A/S. If one or more companies are interposed between Luxco Sarl. and Caymanco Ltd, this may affect the assessment as to whether the company that has formally granted the loan to DK A/S is the rightful recipient. One could imagine that the company in the EU or tax treaty state granting the loan to DK A/S has provided its

capital in the form of contributed capital from another EU or tax treaty company, since local taxation ensures that interest expenses on the loan from Caymanco Ltd. are set off against the interest income from DK A/S. The situation that the company granting the loan to DK A/S does not pay interest will only speak in favor of considering this company as the rightful recipient.

This is not an exhaustive list of the factors that may influence the assessment as to whom is the rightful recipient. Generally, it is the creditor in terms of private law that is the rightful recipient of interest in a tax law context. Only if an overall assessment gives special grounds for departing from this basis can a person other than the creditor be considered the rightful recipient.

The mere fact that a company can be seen as a conduit company is not sufficient to conclude that the company is not the rightful recipient of interest paid from Denmark. Accordingly, it is our view that case law to date does not support the interpretation of the current state of the law indicated by the Danish minister of taxation.

## V. Conclusion and Perspectives

The aim of this article has been to analyze the meaning of beneficial ownership in international group financing. The analysis has included tax treaties, the interest and royalty directive, and Danish tax law. The analysis has tried to provide an improved basis for assessing the risks faced by groups and private equity funds while examining the opportunities available to the Danish tax authorities under current law to challenge existing financing structures using foreign conduit companies.

The notion of beneficial owner was introduced in article 11 of the OECD model treaty in the 1977 review without any clear definition. The OECD commentary has been changed on an ongoing basis; in the review of the model treaty in 2003, the comments on the notion of beneficial owner were expanded. It was provided that the notion of beneficial owner is not used in a narrow technical meaning, but should be seen in light of the treaty's intent and purpose, including avoiding double taxation and preventing tax evasion and tax avoidance. The statement on conduit companies is relevant to the issues discussed in this article. Whether the creditor company is limited in its access to having its assets, including claims, at its disposal is central.

There is consensus in the international tax law literature that the notion of beneficial owner makes it possible to attach importance to the actual ownership rather than the formal ownership. A search for a more precise definition of the notion of beneficial ownership is, however, frequently in vain.

From the tax treaties, it is not certain whether the notion should be understood in accordance with an international autonomous interpretation or domestic law. However, most factors speak in favor of understanding the notion in accordance with an international autonomous understanding, according to which the notion should be assigned an international fiscal meaning. The details of the content remain fairly uncertain, and the existing case law is limited. On the basis of former Danish Supreme Court case law on the interpretation of tax treaties, the Danish courts to some extent seem inclined to interpret the notion of beneficial owner in compliance with domestic Danish tax law.

Beneficial ownership is also a central precondition for applying the interest and royalty directive. The interest and royalty directive implies that interest payments to an associated company in another EU member state will not be subject to withholding tax paid if the interest recipient is the beneficial owner. The directive's definition of the beneficial owner is not yet fully clarified. The wording and correlation with the abuse provision in article 5 probably results in the notion of beneficial owner in article 1(4) being interpreted restrictively, implying only purely artificial transactions when an interposed intermediary, which does not gain any economic benefit from the interest payment, is not to be considered the beneficial owner.

The abuse provision in article 5 of the directive must be considered to reflect the ordinary EU law principle on the prohibition against the abuse of rights and should be interpreted accordingly. The provision can result in the directive's benefits being denied if there is

authority in domestic law. It is a condition that the refusal to grant the directive's benefits is in compliance with article 5 under the interpretation of this provision by the ECJ.

Recently the Danish minister of taxation has attempted to broaden the meaning of "beneficial owner" by using the notion of conduit company as a term for a company that is not at any time to be granted treaty relief for interest or dividends.

It must be expected that the courts will not attach great importance to the minister's comments when assessing whether a company should be considered the rightful recipient and the beneficial owner.

Accordingly, we believe that it is still a general principle in Danish tax law that interest is taxed with the person having the title of the claim in a civil law context. If the rightful recipient of the interest should be considered a person other than the title owner of the claim, case law requires a special reason. Prior Danish case law has not specifically considered a similar situation when a foreign group company that is a creditor to a Danish company has borrowed the funds from another foreign group enterprise. When assessing whether a situation gives grounds for derogating from the clear statement that interest is taxed with the person that has title of the claim in a civil law context, it seems reasonable to assume on the basis of the Supreme Court's practice that one criterion is not decisive, but that an overall assessment will be made on the basis of the existing facts and circumstances. The analysis has provided a number of criteria that may be important when assessing this matter. ♦