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The concept of beneficial owner:

From international tax law to community law

RGSL WORKING PAPERS NO. 26

RIGA, 2005

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The RGSL working papers aim to introduce current legal issues based on research primarily by students and faculty of the RGSL. The paper by Jūlija Petkeviča, based on her Masters Thesis presented in 2004, highlights a complex and highly topical matter that unites international tax law and EU law, at the same time highlighting possible tensions between different systems of law, namely the concept of beneficial owner. This concept is of growing practical interest and importance everywhere in the EU following increased internationalisation and the ensuing increase of tax situations involving more than one country. A good understanding of the concept of beneficial owner is necessary for understanding and applying other notions of tax law and for future legal development in this area.

Jūlija Petkeviča gives a clear and comprehensive introduction to this complex topic and elaborates on the key issues and problems. Her interesting paper provides the reader with a good understanding of why the matter is of interest and what the current situation is. Combining her academic abilities with different practical experience from the tax field, the author is well placed to deal with the issue.

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Introduction

The difficulty, once again, is identifying where beneficial ownership ends and more vague notions of substance over form begin, a point over which there may not be consensus...¹

Within the context of the European Union, the remark made by Joni L. Walser, an international tax lawyer and a panellist in the discussions of the International Fiscal Association in 1998, is rightly supplemented further: “If I am free to move, will I not move to the place where I can optimise my tax burden?”.² These statements demonstrate that there are efforts by governments to secure their revenues and to prevent tax avoidance by looking into the substance and overlooking the form. On the other hand, there is the reality of the EC Treaty and its single market that has a significant impact on traditional governmental views about how tax avoidance should be prevented. The notion of ‘beneficial owner’ in EC tax law synthesises both interests and is designed to draw a line between them.

The concept of ‘beneficial owner’ in EC tax law is a concept deriving its roots from international tax law, where it is deemed to be a concept for prevention of abuse and tax avoidance. It is used to ensure that tax benefits on dividends, interest or royalties moving cross-border are granted only when the recipient is a ‘beneficial owner’ of income. The concept was introduced to EC law in the Directive on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States³ (the Interest-Royalties Directive) with the same purpose. In international tax law, the concept is rarely defined in a binding document. The Interest-Royalties Directive provides for a full definition. The definition is borrowed from the Commentary to the Articles Of The Model Convention With Respect To Taxes On Income And On Capital adopted by the Organisation for Economic Co-operation

¹ Joni L. Walser, Partner Caplin & Drysdale, Washington DC, Panelist in the Seminar held in London in 1998 during the 52nd Congress of the International Fiscal Association, in *The OECD Model Convention - 1998 and beyond; The concept of beneficial ownership in tax treaties. Proceedings of a Seminar held in London in 1998 during the 52nd Congress of the International Fiscal Association*, Kluwer Law International, The Hague-London-Boston, 2000, p. 32.

² David W. Williams, *EC Tax Law*, Longman, London and New York, Singapore, 1998, p. 3.

³ Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States, O.J. L 157 of 26 June 2003.

and Development (OECD Model Convention Commentary)⁴ and explanation given therein, over the precise scope of which there is no general agreement amongst international tax lawyers. That brings the debate over the precise scope of the concept from international law into EC law.

Precise interpretation of the concept in the EC Interest-Royalties Directive has important practical implications. The wider the permitted interpretation, the broader the range of situations where EC tax benefits are denied. And *vice versa*, restrictive interpretation makes EC tax benefits more widely available.

The present paper aims to define the precise scope of the 'beneficial ownership' concept in the Interest-Royalties Directive and to resolve practical problems in its application. The issue is relatively novel, as the concept was introduced in 2004 and no studies of relevant ECJ case law or any other substantial authority were available on this particular subject. Therefore, this paper may contribute to the understanding and interpretation of the concept in EC tax law.

The definition of 'beneficial owner' in EC law is also found in the Council Directive on taxation of savings income in the form of interest payments (the Savings Directive).⁵ The present paper leaves this untouched, as it serves a slightly different purpose than the one in the Interest-Royalties Directive so that comparing them is of little practical importance.

The paper begins with a brief insight into situations where the concept of 'beneficial owner' is at stake and continues with the presentation of relevant provisions of the Interest-Royalties Directive. That will serve as the necessary background for further analysis. The second chapter discusses the debate on the scope of the concept of 'beneficial owner' in international tax law. After international tax law issues are covered, the following chapters address general principles crucial for the interpretation of this concept in EC tax law and analyse ECJ jurisprudence relevant to the interpretation of the concept. The final part applies principles identified to interpretation of the concept in the Interest-Royalties Directive, delivering final conclusions with regard to potential interpretation of the concept of 'beneficial owner' by the ECJ.

⁴ See 2003 version of the OECD Model Convention Commentary to Article 10 of the Model Convention, para. 12.1; commentary to Article 11, para. 8.1 and Article 12, para. 4.1. Available on the internet at: LEXIS-NEXIS database. Last visited at September 14, 2004. The Articles Of The Model Convention With Respect To Taxes On Income And On Capital (OECD Model Convention) as they read on 28 January 2003 are available on the internet at: <http://www.oecd.org/dataoecd/52/34/1914467.pdf>. Last visited February 20, 2005.

1. Preliminary remarks

1.1 When the concept is at stake

The concept of ‘beneficial owner’ helps to decide if a person is eligible for a specific tax benefit under a tax treaty or in EC law, under the Interest-Royalties Directive.

Traditionally within the EU, when a person resident in one state makes an interest or royalty payment to a person resident in another state, the first state may levy a tax on that payment thereby taxing the income of the person resident in that other state.⁶ Imposition of such tax is based on the source principle in international taxation. The source principle means the right of a state to tax the income arising within it⁷ or, in other words, it means that the state taxes domestic income generated within its jurisdiction. Such tax imposed by a state of source may be reduced or even eliminated under the tax treaty or now, within the EU, under domestic provisions implementing the Interest-Royalties Directive.

Under the majority of tax treaties, to be eligible for a tax benefit the recipient of payment is required to be the beneficial owner of income received. Indeed, under the Interest-Royalties Directive one of the conditions to qualify for exemption from tax is that the recipient of interest or royalty should be its ‘beneficial owner’. Failure to meet the beneficial ownership test means a denial of tax exemption even when all other criteria are satisfied in full.

To summarise, the concept of ‘beneficial owner’ is the necessary test which a recipient of interest or royalties must satisfy to be eligible for a tax benefit under either a tax treaty or the Interest-Royalties Directive.

1.2. Legal background

In accordance with the Interest-Royalties Directive, an exemption for cross-border interest and royalty payments may be granted only if the recipient company or permanent establishment is the beneficial owner of interest or

⁵ Council Directive 2003/48/EC of 3 June 2003 on taxation of savings income in the form of interest payments, O.J. L 157 of 26 June 2003.

⁶ In the EU, as of 1 February 2004 all EU Member States levy withholding taxes on certain categories of income arising from their jurisdictions when paid to non-residents. Source: IBFD European Taxation Database. Available on the internet at: <http://ref-online2.ibfd.org/euro/>. Last visited September 6, 2004.

⁷ For definition of source principle of taxation, see, e.g., International Tax Glossary, Amsterdam, IBFD Publications, 2001, p. 324; R. August, International Business Law. Text, Cases and Readings, New Jersey, Pearson Prentice Hall, 2004, p. 719-725.

royalties.⁸ The Directive provides for separate definitions with respect to companies and with respect to permanent establishments.

With respect to companies, Article 1(4) of the Directive provides that:

a company shall be treated as the beneficial owner of interest or royalties only if it receives those payments for its own benefit and not as intermediary, such as an agent, trustee or authorised signatory, for some other person.

Interestingly, the definition is different when applied to permanent establishments. To be precise, under Article 1(5) of the Directive a permanent establishment will be regarded as beneficial owner of interest and royalties if two conditions are fulfilled:

the debt claim, right to use of information in respect of which interest or royalty payments arise is effectively connected with that permanent establishment; and

the interest or royalty represents income in respect of which that permanent establishment is subject to one of the taxes mentioned in the Directive in the Member State in which it is situated (or to a tax, after the entry into force of the Directive, has replaced those existing taxes).

In addition to the definition itself, the other tax-avoidance rules of the Directive are relevant because they serve the same purpose of preventing abuse and avoidance and may assist in interpreting the definition. As far as other anti-abuse provisions are concerned, Recital (6) of the Preamble to the Directive confirms that “it is moreover necessary not to preclude Member States from taking appropriate measures to combat fraud or abuse”. According to Article 5 (1) of the Directive, it “shall not preclude the application of domestic or agreement-based provisions required for prevention of fraud or abuse”. Article 5 (2) further states that Member States are allowed to withdraw the benefits of the Directive or to refuse to apply the Directive, in case of transactions for which the principal motive, or one of the principal motives, is tax evasion, tax avoidance or abuse.

In order to ensure that there “should be no loopholes in the provisions of the Directive allowing for circumvention of taxation of interest and royalty payments”,⁹ the Commission proposed to supplement the existing anti-avoidance rules with an additional one:

Interest or royalty payments arising in a Member State shall be exempt from any taxes imposed on those payments in that State, ..., provided that the beneficial owner of the interest or royalties is a company of another Member State or a

⁸ Article 1(1) of the Directive.

⁹ COM (2003) 841 final: Proposal for a Council Directive amending Directive 2003/49/EC on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States, para. 3. of the Explanatory Memorandum. Available on the internet at: http://europa.eu.int/prelex/detail_dossier_real.cfm?CL=en&DosId=187931. Last visited February 20, 2005.

permanent establishment situated in another Member State of a company of a Member State and is effectively subject to tax on the interest or royalty payments in that other Member State.¹⁰

According to the Commission, Member States have to grant the benefits of the Directive only where interest or royalties are not exempt from tax in the hands of beneficial owner.¹¹ In other words, the source state is not obliged to grant exemption where the payment is not effectively subject to tax in the hands of a recipient.

2. Beneficial owner in international tax law

The concept of ‘beneficial owner’ in EC law was initially borrowed from international tax law. The definition in the Interest-Royalties Directive with respect to companies is rather similar to the explanation of the concept in the OECD Model Convention Commentary. This means that the issues posed with respect to the concept in international tax law remain unresolved in EC law as well. The following outlines the debate over the scope of the concept in international tax law, which reveals issues directly relevant to interpreting the EC concept.

In international tax law, the concept of ‘beneficial owner’ is used in numerous tax treaties concluded since the 1950s.¹² The concept was introduced with respect to dividends, interest, and royalties into Articles 10 to 12 of the OECD Model Convention in 1977. Since then, it has been used in almost every tax treaty based on the OECD Model Convention.¹³ As mentioned in the introduction, the concept traditionally serves as a qualifying test, that is, in determining whether a person qualifies for tax treaty benefits with respect to dividends, interest, or royalties when received from sources in the other contracting state.

The term ‘beneficial owner’ is not defined in the OECD Model Convention. Tax treaties rarely provide for a definition either. For this reason, different views

¹⁰ Ibid, Article 1 of the proposed Council Directive amending the Interest-Royalties Directive.

¹¹ Ibid, Commentary on Article 1 of the proposal for a Directive.

¹² According to search results in Tax Analysts Worldwide Tax Treaties Database. The database is included and available at: LEXIS-NEXIS database. Last visited September 6, 2004.

¹³ E.g. all Latvian tax treaties require a non-resident recipient of cross-border dividends, interest or royalties to be the beneficial owner of this income to qualify for a reduced rate of tax under the treaty. To apply a reduced tax rate under a treaty a non-resident submits a written declaration to the Latvian Revenue certifying his beneficial ownership. The form of declaration is set out in Latvian Cabinet Regulations No. 178 of 30 April 2001 “Kārtība, kādā piemērojami starptautiskos līgumos par nodokļu dubultās uzlikšanas un nodokļu nemaksāšanas novēršanu noteiktie nodokļu atvieglojumi”, Latvijas Vēstnesis 04.05.01 No. 68. Text in English available on the internet at: <http://www.ttc.lv/?id=71>. Last visited February 20, 2005.

have been expressed on how the term should be interpreted. Indeed, the debate on the meaning and the precise scope of the term continues until this day. Controversies are first caused first by disagreement on whether the meaning of the term should be taken from the national law of the respective states, or whether it should be given an autonomous treaty meaning. Even if an autonomous meaning is accepted, the exact scope of meaning provokes further disputes.

According to the general rules of treaty interpretation provided in the Vienna Convention on the Law of Treaties ('the Vienna Convention'), the interpretation of a term used in a treaty should be based on the ordinary meaning of a term, taking into consideration the context as well as the purpose and object of the treaty.¹⁴ However, this general rule cannot be applied to the interpretation of tax treaty terms. For the Vienna Convention stipulates that a special meaning shall be given to a term if it is established that the states so intended¹⁵. Indeed, Article 3(2) of the OECD Model Convention¹⁶ provides exactly for such a specific meaning, in that it states that any term not defined in the tax treaty shall, unless the context otherwise requires, have the meaning that the same term has under domestic law:

As regards application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the purposes of taxes to which the Convention applies, any meaning under applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State.

Therefore, the decisive point for interpretation of the term 'beneficial owner' is whether the context of the treaty requires it to be given an autonomous meaning.

In order to determine whether the context of tax treaties precludes states from applying their domestic definitions of 'beneficial owner', it is necessary to refer to its object and purpose, which provide the general framework for its context. The objectives of tax treaties are granting tax benefits to the residents of the other state, avoidance of double taxation and prevention of fiscal evasion. The obligation to interpret a treaty in good faith found in Article 31 of the Vienna Convention means that a state cannot apply its domestic law in a way that could

¹⁴ 1969 Vienna Convention on the Law of Treaties, Article 31 para. 1, in I. Brownlie (ed.), *Basic Documents in International Law*, Oxford University Press, 1995, p. 401.

¹⁵ Vienna Convention, Article 31 para. 3, *ibid*, p. 402.

¹⁶ The wording of Article 3(2) of the OECD Model Convention is followed by the majority of the EU Member States in the bi-lateral or multilateral tax treaties concluded between them and with third countries.

undermine these objectives.¹⁷ For interpretation of tax treaty terms, the principle of good faith means that interpretation of a term in accordance with national law cannot lead to denial of tax treaty benefits or double taxation. Taking into consideration that no definition is usually present in the law of those countries with a civil law system,¹⁸ resort to general domestic anti-abuse measures of each particular country may lead to substantial differences in applying the same tax treaty. It seems unjust when the same clause negotiated by two countries is applied with a different result depending on which state the payment is coming from, and which domestic definition of ‘beneficial owner’ is invoked. Moreover, a broad interpretation of the term ‘beneficial owner’ may render a treaty partially inoperative where application of extensive domestic anti-abuse measures is scrutinized under this term. Though the purpose of the tax treaty is also the prevention of fiscal evasion, it does not allow a state to apply domestic anti-abuse rules extensively. For these reasons, resort to a domestic meaning of the concept does not facilitate uniformity and is clearly not a result to be welcomed in applying tax treaties.¹⁹ Accordingly, taking into consideration the context of the treaty and the requirement of uniformity of application, at least in the same tax treaty the term ‘beneficial owner’ should not be interpreted unilaterally and should be given an autonomous treaty interpretation.

The first evidence of possible autonomous meaning is found in the OECD Model Convention Commentary. The Commentary represents the consensus reached by OECD Member States and is widely used for interpretation of tax

¹⁷ Note supra 11. National tax law is normally not static and is subject to changes, therefore the usual practice is to re-negotiate the treaties. One recent example is the denunciation by Latvia in 2002 of the tax treaty with Estonia following substantial changes in Estonian income tax system and conclusion of a new one.

¹⁸ Note supra 1, p. 18.

¹⁹ Explicitly supported by H.J.Ault, B.Gouthiere, D.Luthi, B.Wiman in *The OECD Model Convention - 1998 and beyond; The concept of beneficial ownership in tax treaties*, note supra 1, pp. 18-19 and pp. 25-27, supported e.g. by: K.Vogel, *On Double Taxation Conventions. A Commentary to the OECD-, UN- and US Model Conventions for the Avoidance of Double Taxation on income and Capital with particular Reference to German Treaty Practice*, Kluwer Law International, London-The Hague-Boston, 1998, p. 562; P.Baker, *Double Taxation Conventions. A Manual on the OECD Model Tax Convention on income and on Capital*, Sweet and Maxwell, London, 2003, p.10-7; M.Helminen, “Beneficial Ownership of Dividends: Relevance of the New Netherlands Dividend-Stripping Rules in Tax Treaty Situation”, 42 *European Taxation* 11 (2002), p. 459; M.Distaso and R.Russo, “The EC interest and Royalties Directive - A Comment”, 44 *European Taxation* 4 (2004), p. 148; K.Vargas, “Beneficial Ownership Lacks Proper Meaning”, *International Tax Review*, 5 (2004). Available on the internet at: <http://www.legalmediagroup.com/internationaltaxreview/includes/print.asp?SID=3111>. Last visited February 20, 2005. The domestic meaning is advocated by some authors, among them: H. Pijl, H.Pijl, “The Definition of ‘Beneficial Owner’ under Dutch Law”, 54 *Bulletin for International Fiscal Documentation* 6 (2000), at pp. 256-260; P.Valente and M.Magenta, “Analysis of Certain Anti-Abuse Clauses in the Tax Treaty Concluded by Italy”, 54 *Bulletin for International Fiscal Documentation* 1 (2000), at p. 43.

treaties by courts as a subsidiary guide.²⁰ It contains the explanation of the term ‘beneficial ownership’ as follows:

12.1 Where an item of income is received by a resident of a Contracting State acting in the capacity of agent or nominee it would be inconsistent with the object and purpose of the Convention for the State of source to grant relief or exemption merely on account of the status of the immediate recipient of the income as a resident of the other Contracting State. The immediate recipient of the income in this situation qualifies as a resident but no potential double taxation arises as a consequence of that status since the recipient is not treated as the owner of the income for tax purposes in the State of residence. It would be equally inconsistent with the object and purpose of the Convention 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 “Double Taxation Conventions and the Use of Conduit Companies” n13 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.²¹

In brief, in accordance with the OECD Model Convention Commentary the concept of ‘beneficial owner’ excludes:

- 1) mere nominees or agents, who are not treated as owners of the income in their country of residence;
- 2) any other conduit who, though the formal owner of the income, has very narrow powers over it. The narrow powers render the conduit a mere fiduciary or administrator of the income on behalf of the ultimate owner.

In 2003, the OECD Model Convention and its Commentary were revised, resulting in addition of the paragraph cited above (together with identical paragraphs in the Commentary on Articles 10 and 12 explaining the ‘beneficial owner’ concept for interest and royalties). Before 2003, the focus of the OECD Model Convention Commentary centred solely on mere nominees or agents, but

²⁰ In Case C-336/96 *Mr and Mrs Robert Gilly v Directeur des services fiscaux du Bas-Rhin* [1998] ECR I-02793, the ECJ made explicit reference to the Commentary in para. 31 of the judgment and used it as an authoritative guide to resolve the case. The importance of the OECD Model Convention Commentary is acknowledged by numerous court decisions all over the world, including EU Member States and Norway and, for example, India. For a more detailed analysis of the status of the OECD Model Convention Commentary in each EU Member State and Norway see M.Lang (ed.), *Tax Treaty Interpretation*, Kluwer Law International, The Hague-London-Boston, 2000, and M.Butani, “Tax Treaty Interpretation”, 10 *Asia-Pacific Tax Bulletin* 1 (2004), pp. 62-65.

²¹ OECD Model Convention Commentary, note supra 4, a commentary to Article 10, para. 12.1. Identical wording is used for commenting the ‘beneficial owner’ concept in the OECD Model Convention Commentary to Article 11, para. 8.1 and Article 12, para. 4.1 on taxation of interest and royalties respectively.

conduit companies were not mentioned.²² The insertion of an additional explanation in para.12.1 of the Commentary was clearly inspired by the OECD report “Double Taxation Conventions and the Use of Conduit Companies”. The argument was that, on the basis of this report and the OECD Model Convention Commentary, a state may be entitled not to regard a person as a ‘beneficial owner’ of income if “there is an arrangement whereby reduced rate would economically benefit another person who is not a resident of the contracting state”.²³ This view had also been advocated by scholars before the 2003 revision of the OECD Model Convention Commentary.²⁴ On the other hand, the clear extension of the concept of ‘beneficial owner’ from mere agents to so-called conduit entities and persons in the 2003 revision was heavily criticised as extending too far the powers of tax administrations to apply tax avoidance laws: the revision was regarded as the situation of “overprotection at the OECD level of the interests of tax administrations”, which even “calls for reaction”.²⁵

The case law dealing with the concept of ‘beneficial owner’ in tax treaties does not follow one line of interpretation of the concept. Some decisions interpreting the concept are clearly in favour of both narrower and wider interpretations.

In contrast to the present version of the OECD Model Convention Commentary, the decision of the Dutch Supreme Court of 6 April 1994 concentrates on the fact that a person receiving dividend income had full legal ownership rights and was therefore itself entitled to freely dispose of dividend coupons and dividend income.²⁶ For these reasons, this person was not considered to be an agent or nominee. The Dutch court did not apply the ‘substance over form’ principle but focused on the fact that legal ownership formally granted broad powers to the owner of dividend coupons. Consequently, this decision can be cited in support of a narrower interpretation of the ‘beneficial owner’ concept. A later decision of the Dutch Supreme Court of 21 February 2001

²² See 1995 version of the OECD Model Convention Commentary, available on the Internet at: LEXIS-NEXIS database. Last visited September 14, 2004.

²³ M.Helminen, note supra 19, p. 457.

²⁴ For example, by Vogel, note supra 19, p. 561, who states that “Treaty benefits should not be granted with a view to a formal title to dividends, interest or royalties, but to the ‘real’ title. In other words, the old dispute ‘form versus substance’ should be decided in favour of ‘substance’.”

²⁵ A.Jiménez, “The 2003 Revision of the OECD Commentaries on the Improper Use of Tax Treaties: A Case for the Declining Effect of the OECD Commentaries?” 58 Bulletin for International Fiscal Documentation 1 (2004), p. 29.

²⁶ Decision of Supreme Court (Hoge Raad) of 6 April 1994, No.28 638, BNB 1994/217, cited and discussed by: M.Helminen, note supra 19, p. 458; H.Pijl, note supra 19, pp.257-258; P.Baker, note supra 19, pp. 10-6.

discusses the case where a broker bought shares one day before dividends were declared and sold the same shares one day after declaration of dividends.²⁷ In this case, the broker was considered to have his own business purpose and participated in an arrangement not with the purpose of avoiding taxes.²⁸ The reasoning used in this case inclines more to applying the ‘substance over form’ rule and suggests that a broad interpretation could be used by the court.

In a recent decision coming from Swiss jurisdiction, the Swiss Federal Tax Appeals Commission - referring to principles of interpretation provided in the Vienna Convention - interpreted the notion ‘*bénéficiaire*’ (in English - *beneficiary*) of the Luxembourg-Swiss tax treaty.²⁹ That treaty did not provide for any other specific anti-abuse rules, except the ‘*bénéficiaire*’ notion. The Commission recognised the notion as having the same meaning as ‘*bénéficiaire effectif*’.³⁰ In a situation where dividends were remitted to a holding company in Luxembourg and further to two UK shareholders of the Luxembourg company, the Commission ruled that the Luxembourg company was not the beneficiary of dividend income and refused application of a zero withholding tax rate on dividends paid from Switzerland to Luxembourg. The circumstances taken into consideration were that the shares in the Swiss company were the only asset of the Luxembourg company and that the Luxembourg company did not report any profit in Luxembourg. The Commission concluded that there was no business purpose in the existence of this company. It was a mere conduit interposed in order to shop for a zero rate under the Luxembourg-Swiss tax treaty. Thus, this decision evidently favours the broad interpretation of the ‘beneficial owner’ concept, looking rather at economic substance than legal form.

In addition, several tax rulings from South-Korean Ministry of Finance and Economy demonstrate that conduit companies interposed between the payer and the recipient of income were not its beneficial owners and were designed to ‘shop’ for lower rates under the treaties.³¹ In contrast to South Korea, recent information indicates that Taiwan does not impose limits on such treaty shopping

²⁷ Decision of Supreme Court (Hoge Raad) of April 1994, No.28 638, BNB 1994/217, cited and discussed by: M.Helminen, note supra 19, p. 458.

²⁸ Ibid.

²⁹ Decision of Swiss Federal Tax Appeals Commission of 28 February 2001, cited and discussed in much detail by: P.Reinarz, “Treaty Shopping and the Swiss Withholding Tax Trap”, 41 European Taxation 11 (2001), pp. 420-422.

³⁰ ‘*Bénéficiaire effectif*’ is the French version of ‘beneficial owner’.

³¹ Jaekukjo (tax ruling) 46017-61 dated 20 April 2000, Jaekukjo (tax ruling) 46017-106 dated 10 August 2000 and Seo (tax ruling) 46017-10281 dated 20 February 2002, cited and explained in: D.Kim, “South Korea. Withholding Tax Planning Techniques”, 6 Asia-Pacific Tax Bulletin 8 (2000), p. 293.

provided that the recipient of income is a formal owner and resident in the other contracting state.³²

Thus, analysis of OECD Model Convention Commentary, opinions stated in legal literature on this topic, and the decisions described above show that until now the precise scope of the concept of ‘beneficial owner’ in tax treaties is not clear. Under international law, the concept may be interpreted narrowly, as excluding mere agents and nominees only, or broadly allowing denial of treaty benefits to any interposed entity or person that is the formal owner of income but transfers it further to the real beneficiaries. As far as EC law is concerned, the interpretation of the term in international tax law may be used as a basis for interpreting this concept in the EC Interest-Royalties Directive, paying due regard to the principles and peculiarities of Community law.

3. Principles underlying interpretation of the concept in Community law

This part deals with the main principles crucial to the interpretation of a concept of ‘beneficial owner’ as a concept introduced by means of (i) positive harmonisation (ii) in the sphere of direct or company taxation, (iii) taking into account the case-law of the ECJ. First, the concepts of EC law have been consistently interpreted as autonomous concepts and the paper considers the relevance of autonomous interpretation method with respect to the concept of ‘beneficial owner’ in the Interest-Royalties Directive. The paper then proceeds with a discussion of the main principles underlying integration in the area of direct taxes the impact of ‘negative integration’ advanced by the ECJ. This analysis leads to preliminary conclusions on the interpretation of the concept and how harmonisation methods may influence its scope.

3.1. EC law concepts as autonomous concepts

The monopoly of the final word in interpreting EC law lies with the ECJ.³³ The ECJ has consistently stressed the need for a uniform interpretation of EC law, because EC law is a legal system common now to twenty-five Member States with different

³² K. Wu, “Withholding Tax Planning Techniques in Taiwan”, 9 Asia-Pacific Tax Bulletin 8 (2003), pp. 294-295.

³³ Article 220 and Article 292 of the EC Treaty.

legal traditions and it undergoes a complex and often lengthy procedure of adoption³⁴.

According to the ECJ, the need for uniform interpretation leads to the method of autonomous interpretation of EC law provisions:

According to settled case-law, the need for uniform interpretation of Community law ... require[s] that the terms of a provision of Community law which makes no express reference to the law of the Member States for the purpose of determining its meaning and scope must normally be given an autonomous and uniform interpretation throughout the Community; that interpretation must take into account the context of the provision and the purpose of the legislation in question.³⁵

These principles apply to the interpretation of the provisions of EC directives in the sphere of company taxation. With regard to the Parent-Subsidiary Directive and the concept of withholding tax, the ECJ has stated:

It would be contrary to the principle of uniform interpretation of Community law if the definition of a withholding tax within the meaning of Article 5 (1) of the Directive, the characteristics of which are set out in the case-law referred to in paragraph 47 of this judgement, could depend on the percentage at which the tax at question is set.³⁶

Henceforth, and following these principles elaborated by the ECJ, the concept of 'beneficial owner' should be interpreted autonomously as an EC law concept with particular regard to the context of the definition and purpose of the Interest-Royalties Directive.³⁷

Moreover, autonomous interpretation is required by the very practical aspect of applying the Interest-Royalties Directive. The Directive allows Member States to apply the benefits conditionally on the presenting of an attestation, which must contain certain information specified by the Directive.³⁸ This attestation is required to contain, *inter alia*, proof of tax residence of the recipient of income certified by the tax authorities and information on beneficial ownership. Though the provisions of the Directive are vague and it is not clear whether the tax authority also certifies the information on beneficial ownership, it was suggested that the whole attestation should be issued and signed by the

³⁴ These factors are underlined by N.Reich, *Understanding EU Law*, Intersentia, Antwerp-Oxford-New York, 2003, p. 25.

³⁵ Case C-373/00 *Adolf Truly GmbH v Bestattung Wien GmbH* [2003] ECR I-01931, para. 35. Almost the same is reiterated in Case 327/82 *Ekro BV Vee- en Vleeshandel v Produktschap voor Vee en Vles* [1984] ECR 00107, para. 11; Case C-287/98 *Linster and others* [2000] ECR I-6917, para. 43; Case C-357-98 *Yiadam* [2000] ECR I-9265, para. 26.

³⁶ Case C-58/01 *Océ van der Grinten NV v Commissioners of Inland Revenue* [2003] ECR I-0980.

³⁷ An autonomous interpretation of the term 'beneficial owner' was already mentioned by L.Hinneken, "European Commission introduces beneficial ownership in latest tax directives proposals adding to the confusion with regard to its meaning", *EC Tax Review* 1 (2000), p. 44.

³⁸ Article 1 (11)-(13) of the Interest-Royalties Directive.

tax authority of the recipient of interest or royalties.³⁹ If so, then the question arises whether the source state is bound by the assessment of beneficial ownership carried out by the tax authorities of the other Member State. Assessment of beneficial ownership by both source and recipient Member States is to be carried out on the basis of national law implementing the Directive. Under EC law, it seems not possible to arrive at different results in applying an EC measure. The Directive should be applied uniformly throughout the EU; conflicts resulting from different interpretations of a concept in the Directive are not permissible.

It follows from the principle of autonomous interpretation developed by the ECJ, and from the practical aspects of applying tax benefits under the Directive, that the concept of 'beneficial ownership' is an autonomous Community concept and its interpretation must not differ between any of the Member States.

3.2. Concept of 'beneficial owner' as a harmonisation measure

The Interest-Royalties Directive is a measure for harmonising certain aspects of direct taxation within the EU. Thus, for a sound interpretation of the provisions of the Directive it is necessary to understand the principles underlying the harmonisation of direct tax matters and taxation of cross-border payments of interest and royalties. The scope of the concept of 'beneficial owner' in EC tax law and its permissible interpretation depends on whether the concept is introduced into EC law through total harmonisation or whether it is introduced as a minimum harmonisation measure. The answer to this question could be used as an argument in support of a broader or narrower interpretation.

To this end, the principle of subsidiarity is important in harmonising company taxation in the EU and essentially means that Community measures should not go beyond what is necessary to achieve an objective. According to Article 5(1) of the EC Treaty, the Community is obliged to act within the limits of powers conferred upon it by the EC Treaty. Furthermore, Article 5(2) and (3) of the EC Treaty stipulate:

In areas which do not fall within its exclusive competence, the Community shall take action in accordance with the principle of subsidiarity, only if and in so far

³⁹ L.Cerioni, "Intra-EC Interest and Royalties Tax Treatment" 44 European Taxation 1 (2004), p.52.

as the objectives of the proposed action cannot be sufficiently achieved by the Member States

Any action by the Community shall not go beyond what is necessary to achieve the objectives of this Treaty.

Since direct taxes do not fall within Community exclusive competence, it was argued that EC measures should be limited to the necessary minimum.⁴⁰ This view seems to be supported, for example, by James, who states that “the case against harmonisation is really the case against complete harmonisation”.⁴¹ Following the Commission’s Communication “Towards an Internal Market without tax obstacles”⁴² it was likewise suggested that the EU Model Tax Treaty would be appropriate in a form of non-binding recommendation only, leaving the way for abolition of double taxation by the traditional means of bilateral agreements.⁴³ Accordingly, taking into consideration the principle of subsidiarity and views expressed, it is concluded that the Member States must enjoy a wide discretion in the field of direct taxation. With regard to the Interest-Royalties Directive, the principle of subsidiarity is expressly mentioned in Recital (10) of the Directive. Therefore, the Directive governs the necessary minimum, so that the rest is left to the competence of the Member States.

This conclusion means that Member States are free to introduce more favourable standards of taxation than those provided by the Interest-Royalties Directive. On the other hand, Member States are not allowed to introduce more stringent measures that can restrict the favourable regime established by the provisions of the Interest-Royalties Directive. The minimum harmonisation principle underlying the Directive stands for a restrictive interpretation of the definition of ‘beneficial owner’. The Member States may pursue a certain interpretation, but this interpretation must not go beyond the boundaries in prejudice to the favourable tax regime under the Interest-Royalties Directive.

The same principle is valid for other general provisions against tax abuse and evasion in the Directive. These measures include Recital (6) and Article 5 of the Interest-Royalties Directive. Recital (6) in the Preamble of the Directive states that Member States are not precluded from taking measures to prevent

⁴⁰ M. Lechner, “The Influence of EU Law on Tax Treaties from a German Perspective”, 54 Bulletin for International Fiscal Documentation 8/9 (2000), pp. 461-470.

⁴¹ S. James, “Can We Harmonise Our Views on European Tax Harmonisation?” 54 Bulletin for International Fiscal Documentation 6 (2000), p. 269.

⁴² COM (2001) 582 final. Available on the internet at: http://europa.eu.int/prelex/detail_dossier_real.cfm?CL=en&DoslD=168921. Last visited February 20, 2005.

⁴³ G. Maisto, “Shaping EU Company Tax Policy: The EU Model Tax Treaty”, 42 European Taxation 8 (2002), p. 308.

fraud and abuse. Furthermore, Article 5 of the Directive explicitly authorises Member States not to apply the Directive in situations of tax avoidance or evasion. These provisions do not impose any precise criteria as to situations when tax benefits can be denied. Therefore, the maximum permissible limits precluding the application of the Directive are left within the final say of the ECJ.

Accordingly, the method of minimum harmonisation supports interpretation of the concept of 'beneficial owner' as restricted by certain boundaries. These boundaries represent the limits over which interpretation of the term would prejudice application of a favourable tax regime provided for in the Interest-Royalties Directive. Member States are free to introduce less restrictive measures, thereby granting its nationals wider access to the tax benefits under the Directive.

It should be noted that Member States have always been reluctant to harmonise direct taxation: so far, only four positive harmonisation measures - including the Interest-Royalties Directive - have been adopted in the sphere of company taxation.⁴⁴ Lack of progress in positive harmonisation of company taxation can be explained by difficulties in reaching consensus in the Council, despite the fact that direct taxes do affect investment, establishment, and employment decisions of EU nationals. Harmonisation of direct taxation implies the need to reconcile the substantial differences in taxation systems between EU Member States. At the same time, as Terra and Wattel suggest, the history of integration in this sphere shows that Member States defend their direct tax sovereignty "as if it were their virginity".⁴⁵ Lack of action by Member States has already led to 'negative harmonisation', when the removal of existing barriers is done by the ECJ by way of striking down national laws on a random and uncontrolled basis. This trend is confirmed by the pending *Marks & Spencer* case,⁴⁶ where the ECJ is asked to rule on the availability of cross-border set-off losses under the EC Treaty. The decision in this case may potentially turn out to be a negative harmonisation in lieu of the Commission's proposal on loss offset

⁴⁴ The other three are the Merger Directive, note infra 56, the Parent-Subsidiary Directive, note infra 66, and the Savings Directive, note supra 5.

⁴⁵ B.Terra, P.Wattel, *European Tax Law*, Kluwer Law International, The Hague, 2001, p.152.

⁴⁶ Case C-446/03 *Marks & Spencer plc v David Halsey* (HM Inspector of Taxes), pending, reference for a preliminary ruling by the High Court of Justice (England & Wales), Chancery Division, O.J. C 304 of 3 December 2003, p. 18-19.

cross-border.⁴⁷ The Member States could not agree on the proposal, which was withdrawn by the Commission on 11 December 2001.

A trend towards ‘negative harmonisation’ demonstrates the increasing importance of the ECJ in the sphere of harmonisation of direct taxation. Therefore, the next section addresses the ECJ’s interpretation of anti-abuse measures in the light of the EC Treaty freedoms.

3.3 Measures to prevent abuse in the direct taxation field and the role of the ECJ

The ECJ has recognised that “direct taxation falls within the competence of Member States” but the Member States “must nonetheless exercise these competence consistently with Community law”.⁴⁸ With respect to the freedom of Member States to enact anti-abuse measures in the direct taxation sphere, the evolution of ‘negative harmonisation’ led by the ECJ may be divided into two periods. In terms of time, these periods approximately reflect the general intensity of the activity of the ECJ in the sphere of direct taxation.

3.3.1. First period: not much interference

The first phase starting from the very foundation of the EC until the *Schumacker*⁴⁹ decision could be described as limited application of the EC Treaty freedoms to anti-abuse measures against tax avoidance. *Schumacker* did not deal with the matters of abuse at all. Nonetheless, it was the *Schumacker* judgment where the ECJ first pointed out that the competence of Member States in direct taxation should be exercised in accordance with EC law. The decision indicated that the application of anti-avoidance measures to safeguard tax revenues of the Member States may be subject to careful assessment by the ECJ.

⁴⁷ COM (1990) 595, Proposal for a Council Directive concerning arrangements for the taking into account by enterprises of the losses of their permanent establishment and subsidiaries situated in other Member States. Text of the proposal and its adoption progress is available on the Internet at: http://europa.eu.int/prelex/detail_dossier_real.cfm?CL=en&DosId=11773. Last visited February 20, 2005.

⁴⁸ Case 279/93 Finanzamt Köln-Altstadt v Roland Schumacker [1995] ECR I-225, paras. 21 and 26; Case C-80/94 G. H. E. J. Wielockx v Inspecteur der Directe Belastingen [1995] ECR I-02493, para.16; Case C-107/94 Asscher v Staatssecretaris van Financiën [1996] ECR I-0308, para. 36; Case C-294/97 Eurowings Luftverkehrs AG v Finanzamt Dortmund-Unna [1999] ECR I-07447, para. 32; Case C-35/98 Staatssecretaris van Financiën v B.G.M. Verkooijen [2000] ECR I-04071, para. 32; Case C-334/02 Commission of the European Communities v French Republic [2004] ECR 0000, para. 21; Case C-315/02 Annelize Lenz v Finanzlandesdirection fur Tirol [2004] ECR 0000, para. 19.

⁴⁹ Case Schumacker, note supra 48.

Before *Schumacker*, in the widely reported *Daily Mail*⁵⁰ case, a UK corporation sought to transfer its central management and control to the Netherlands. The main purpose of such transfer was the avoidance of UK tax on capital gains.⁵¹ The transfer required the consent of the UK Treasury, which insisted that at least some portion of assets should be sold and the tax paid before the transfer. It was argued by the *Daily Mail* that the need for approval is an obstacle to the exercise of freedom of establishment and the dispute reached the ECJ. The ECJ answered the questions on the basis of the right of establishment, stating that differences in company law provisions are still not harmonised and can be maintained by Member States. The reasoning adopted relieved the ECJ from going into assessment of the requirement of UK Treasury approval as a measure to prevent tax avoidance and this was upheld by the Court. The decision was criticised as “not focusing on the actual problem”.⁵²

Thus, in the *Daily Mail* judgement a measure in essence designed to prevent tax avoidance was upheld by the ECJ. The ECJ’s conclusion may have been influenced by the fact that no direct tax measures were in force at that time. In 1988, taxation was not perceived as an obstacle for the exercise of freedoms in the internal market. If the judgement were given today, the outcome might be different, or at least the measure would be subject to much more serious scrutiny by the ECJ.

3.3.2. Second period: active development of case-law based rules

The second period starts with the *Schumacker*⁵³ decision of 1995. As stated previously, since then Member State measures in the direct taxation sphere have been proclaimed as potentially subject to ECJ jurisdiction from the perspective of strict compliance with EC Treaty freedoms. The *Schumacker* decision can also be viewed as a starting point for the development of case law in the direct taxation field. Since *Schumacker*, the Court’s jurisprudence has been described as “the success story of taxpayers and the defeat of ‘fiscal interests’ of the Member States”,⁵⁴ with eventually no steps back by the ECJ.⁵⁵ Taxpayers also proved

⁵⁰ Case 81/87 *The Queen v H.M. Treasury and Commissioners of Inland Revenue, ex parte Daily Mail and General Trust plc.* [1988] ECR 05483.

⁵¹ *Ibid*, para. 7, where this motive was defined as “principal reason for the proposed transfer” and as “common ground”.

⁵² P. Pistone, *The Impact of Community Law on Tax Treaties: Issues and Solutions*, Eucotax, Kluwer Law International, The Hague-London-New York, p. 109.

⁵³ Note supra 48.

⁵⁴ Though in relation to the whole case law of the ECJ in direct taxation this was rather accurately indicated by A. Jimenéz, note supra 25, p. 29.

successful in challenging Member States' anti-abuse measures before the ECJ. Although the jurisprudence is still developing, it is possible to identify several tests employed by the ECJ in scrutinising anti-abuse measures in the field of direct taxation.

The ECJ first began with prohibition of anti-abuse rules of too broad and general nature. Not long after followed the *Leur Bloem* case, which dismissed the refusal of Dutch tax authorities to grant tax benefits arising out of the so-called Merger Directive on the basis of tax avoidance.^{56 57} In this case, the taxpayer carried out a merger where the acquiring company did not itself carry on business. The purpose of the merger was actually the opportunity to set-off and use losses for tax purposes. Otherwise the set-off losses were not available. The national court asked whether the benefits of the directive could be refused under these circumstances and whether the purpose of setting-off losses constituted a valid commercial reason. At first glance, the Merger Directive gives a wide discretion to Member States by allowing withholding of application of the benefits of the directive where the principal objective of the transaction is tax avoidance. It states that where the operation "is not carried out for valid commercial reasons ... [it] may constitute a presumption that the operation has tax evasion or tax avoidance as ... one of its principal objectives".⁵⁸ However, the ECJ ruled in favour of the taxpayer:

... the laying down of a general rule automatically excluding certain categories of operations from the tax advantage, on the basis of criteria such as those mentioned in the ... question [of national court], whether or not there is actually tax evasion or tax avoidance, would go further than is necessary for preventing such tax evasion or tax avoidance and would undermine the aim pursued by the Directive.

This ruling condemns the adoption of general rules by the Member States automatically excluding certain situations from the benefits of EC law. The ECJ reasoning cited above has been reiterated in many subsequent cases dealing with tax avoidance measures in the sphere of direct taxation whether decided on the basis of freedom of establishment or free movement of capital or even both.⁵⁹

⁵⁵ Case C-112/91 *Hans Werner v Finanzamt Aachen Innenstadt* [1993] ECR I-449, for example, may be described as a step back, where a discriminatory measure was not outlawed by the ECJ.

⁵⁶ Council Directive 90/434/EEC of 23 July 1990 on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States, O.J. L 225 of 20 August 1990.

⁵⁷ Case C-28/95 *A. Leur-Bloem v Inspecteur der Belastingdienst/Ondernemingen Amsterdam 2* [1997] ECR I-04161.

⁵⁸ Article 11(1)(a) of the Merger Directive, note supra 56.

⁵⁹ Case C-264/96 *Imperial Chemical Industries plc (ICI) v Kenneth Hall Colmer (Her Majesty's Inspector of Taxes)* [1998] ECR I-04695, para. 26; Case C-478/98 *Commission of the European*

Secondly, by developing criteria for application of anti-abuse measures by Member States the ECJ has established an extremely strict test of ‘purely artificial arrangement’ for justification of anti-abuse measures:

It should be noted that Article ... is not specifically designed to exclude from a tax advantage purely artificial arrangements aimed at circumventing French tax law, but is aimed generally at any situation in which a taxpayer with substantial holdings in a company subject to corporation tax transfers his tax residence outside France for any reason whatsoever.⁶⁰

The meaning of ‘purely artificial arrangements’ for tax purposes has been never explained by the ECJ. Still, the *Leur Bloem*⁶¹ decision can be used to clarify the meaning of ‘valid commercial reasons’ and assist in interpreting the ‘artificial arrangements’ concept. In *Leur Bloem*, the ECJ accepted that “‘valid commercial reasons’ is a concept involving more than the attainment of a purely fiscal advantage”.⁶² The Court has acknowledged that a transaction “having only such aim cannot therefore constitute a valid commercial reason”.⁶³ Following this conclusion, it may be suggested that ‘purely artificial arrangements’ are arrangements lacking valid commercial reasons and the arrangements to gain only fiscal advantages should be declared artificial. In practice, however, the taxpayer may organise an operation such a way as to be supported with other valid commercial reasons and will in most cases do so. In abuse cases, the burden of proof is on the tax authorities.⁶⁴ In these circumstances, proof of the sole intention of the taxpayer seems not easy, if not impossible.

Analysis of ECJ jurisprudence reveals that the ECJ does not cite this stringent test of ‘purely artificial arrangement’ in every case when it has to deal with Member State measures that are argued to be justified by the need to prevent tax avoidance. Nevertheless, in other decisions where this test is not directly present the measure of a Member State is subject to the strict proportionality test.

Thirdly, proportionality in dealing with restrictions on EC Treaty freedoms arising out of a measure in direct taxation is developed by the ECJ based on

Communities v Kingdom of Belgium [2000] ECR I-07587, para. 45; Case Commission v France, note supra 48, para. 27; Case C-436/00 X and Y v Riksskatteverket [2002] ECR I-10829, para.61; Case C-9/02 Hughes de Lasteyrie du Saillant v Ministère de l'Économie, des Finances et de l'Industrie [2004] ECR 00000, para. 50.

⁶⁰ Case Saillant, *ibid*, para. 50; also stated in Case ICI, *ibid*, para. 26; Case X and Y, *ibid*, para. 61, Case C-324/00 Lankhorst-Hohorst GmbH v Finanzamt Steinfurt [2002] ECR I-11779, para. 37.

⁶¹ Note supra 57.

⁶² *Ibid*, para. 47.

⁶³ *Ibid*.

⁶⁴ The same conclusion is reached by O.Thömmes, K.Eicker “Limitation on Benefits: The German View. Sec.51d(1a) Individual Income Tax Act and EC Law Issues”, 39 *European Taxation* 1 (1999), p. 13.

traditional methods of applying the proportionality principle. Thus in *Denkavit*⁶⁵, concerning implementation of a provision of the so-called Parent-Subsidiary Directive⁶⁶, the rule in question constituted derogation from the exemption principle. The ECJ clearly stated that derogation should be interpreted strictly and could not “go beyond the actual words” of the provision, “to the detriment of beneficiary undertakings”.⁶⁷ In *Futura*⁶⁸ it was argued that a requirement imposed on Luxembourg branches of foreign companies to keep proper accounts when a branch intends to carry-forward losses is in breach of freedom of establishment. In this case, the ECJ referred to the general proportionality principle⁶⁹ as established by *Gebhard*,⁷⁰ *Kraus*⁷¹, and *Bosman*⁷². Since then, every measure in the direct taxation field pleaded to be justified as an anti-avoidance measure has been examined on the basis of the proportionality test. It is rather interesting that in these cases the ECJ subjects the measure to an extremely thorough examination from a very practical perspective: it may point to other similar situations where a Member State did not adopt any restrictive measures⁷³ or even directly suggest other means to achieve the aim pursued.⁷⁴

Next, in evaluating anti-abuse measures, the ECJ often reminds the Member States of the principle of mutual recognition. The fact that the income of a taxpayer will be subject to tax in another Member State is a factor often taken into account by the ECJ.⁷⁵ This can be viewed as an expression of the “mutual recognition principle” in the field of direct taxation. Mutual recognition of tax systems is employed by the ECJ as a counter-argument against imposing excessive restrictions and the claims of loss of tax revenue by individual Member States.

⁶⁵ Joined cases C-283/94, C-291/94 and C-292/94 *Denkavit International BV, VITIC Amsterdam BV and Voormeer BV v Bundesamt für Finanzen* [1996] ECR I-05063.

⁶⁶ Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, O.J. L 225 of 20 August 1990.

⁶⁷ Case *Denkavit*, note supra 65, para. 27.

⁶⁸ Case C-250/95 *Futura Participations SA and Singer v Administration des contributions* [1997] ECR I-02471.

⁶⁹ *Ibid*, para. 26, the same reiterated in *Océ*, note supra 36, para. 86.

⁷⁰ Case C-55/94 *Reinhard Gebhard v Consiglio dell'Ordine degli Avvocati e Procuratori di Milano* [1995] ECR I-04165, para. 37.

⁷¹ Case C-19/92 *Dieter Kraus v Land Baden-Württemberg* [1993] ECR I-01663, para. 32.

⁷² Case C-415/93 *Union royale belge des sociétés de football association ASBL v Jean-Marc Bosman, Royal club liégeois SA v Jean-Marc Bosman and others and Union des associations européennes de football (UEFA) v Jean-Marc Bosman* [1995] ECR I-04921, para. 104.

⁷³ For example, Case *Commission v Belgium*, note supra 59, para. 46.

⁷⁴ For example, Case *Saillant*, note supra 59, para. 54; Case *Commission v France*, note supra 48, para. 30.

⁷⁵ For example, Case *ICI*, note supra 59, para. 26.

Finally, the cases of *Centros*,⁷⁶ *Inspire Art*⁷⁷ and *Eurowings*⁷⁸ are crucial for interpreting the concept of ‘beneficial owner’, even although they are not directly connected with tax abuse measures. The broader interpretation of the ‘beneficial owner’ concept, which seems permissible under the 2003 version of the OECD Model Convention Commentary, allows denial of benefits in treaty-shopping situations. The judgements in *Centros* and *Inspire Art* allowed use of freedom of establishment and to ‘shop’ for a more favourable company law jurisdiction, thereby circumventing the more stringent requirements of national law. In contrast to the interpretation advocated by the OECD Model Convention Commentary, these judgments support the narrow interpretation of the concept of ‘beneficial owner’.

In both cases, a company was established in the UK where the requirements of share capital and registration formalities are least burdensome. Afterwards, a branch was applied for registration in a state where actual business activities were planned to be carried out. By its decisions in *Centros* and *Inspire Art*, the ECJ dismissed the claims of governments on circumvention of national laws. With respect to *Centros*, it was stated that “a situation which admittedly seemed like an obvious case of circumvention came out as a part of the essence of the right to free movement of establishment!”.⁷⁹ A similar statement is applicable to *Inspire Art*, where the ECJ just confirmed its *Centros* judgement.

Various grounds claimed by Member States to justify their restrictions, *inter alia* the prevention of abuse, were not accepted by the ECJ in these judgements. To the contrary, the ECJ stressed that the differences of national company laws may be exploited and such exploitation is inherent in the freedom of establishment:

... as the Court confirmed in paragraph 27 of *Centros*, the fact that a national of a Member State who wishes to set up a company can choose to do so in the Member State the company-law rules of which seem to him the least restrictive and then set up branches in other member States is inherent in the exercise, in a single market, of the freedom of establishment guaranteed by the Treaty.⁸⁰

⁷⁶ Case C-212/97 *Centros Ltd v Erhvervs- og Selskabsstyrelsen* [1999] ECR I-01459.

⁷⁷ Case C-167/01 *Kamer van Koophandel en Fabrieken voor Amsterdam v Inspire Art Ltd* [2003] ECR I-10155.

⁷⁸ Case *Eurowings*, note supra 48.

⁷⁹ A.Kjellgren, “On the Border of Abuse: ECJ on Misuses of EC Law”, in M.Andenas, W.-H.Roth (eds), *Services and Free Movement in EU Law*, Oxford University Press, New York, 2002, p.273.

⁸⁰ Case *Inspire Art*, note supra 77, para. 138.

Further, it was also confirmed once again that the fact that the company does not conduct any business in the Member State of registration is not sufficient to prove abuse or fraudulent conduct.⁸¹

There have been other cases where misuse of EC law was recognised by the ECJ. However, these decisions are different from *Centros* and *Inspire Art* for the following reasons:

- these decisions concern a purely artificial and rather simple chain of transactions, e.g. export and immediate re-importation, in order to access benefits under EU or national laws,⁸² or
- these decisions concern U-turn constructions to circumvent national laws which are or may be recognised as **valid restrictions** of the EC freedoms on the basis of EC law.⁸³

The *Eurowings* case was decided shortly after *Centros*. This concerned the (now abolished) German trade tax and discrimination in the field of freedom to provide services. The tax in question was imposed on the value of assets of a German company, also leased from other companies. In this case, a German lessor was not entitled to relief on aircraft leased from an Irish company, whereas the relief would be available where the assets were leased from a German resident entity. The ECJ stated that this amounted to discrimination prohibited by freedom to provide services. The ECJ dismissed the justification of the German government claiming that the Irish company was not subject to a similar tax in Ireland and was generally subject to lower taxation:

44. Any tax advantage resulting for providers of services from the low taxation to which they are subject, in the Member State in which they are established cannot be used to justify less favourable treatment in tax matters given to the recipients of services established in the later State (see ... *Commission v France*⁸⁴, paragraph 21, and *Asscher*⁸⁵, paragraph 53, ...).

⁸¹ Ibid, para. 139. First stated in Case 79/85 D. H. M. Segers v Bestuur van de Bedrijfsvereniging voor Bank- en Verzekeringswezen, Groothandel en Vrije Beroepen [1986] ECR 02375, para. 16 and confirmed in *Centros*, note supra 76, para.29.

⁸² Case 229/83 Association des Centres distributeurs Édouard Leclerc and others v SARL "Au blé vert" and others [1985] ECR 00001; Case C-221/89 The Queen v Secretary of State for Transport, ex parte Factortame Ltd and others [1991] ECR I-03905; Case C-8/92 General Milk Products GmbH v Hauptzollamt Hamburg-Jonas [1993] ECR I-00779; Case C-110/99 Emsland-Stärke GmbH v Hauptzollamt Hamburg-Jonas [2000] ECR I-11569.

⁸³ Case 33/74 Johannes Henricus Maria van Binsbergen v Bestuur van de Bedrijfsvereniging voor de Metaalnijverheid [1974] ECR 01299; Case C-61/89 Criminal proceedings against Marc Gaston Bouchoucha [1990] ECR I-03551; Case C-370/90 The Queen v Immigration Appeal Tribunal et Surinder Singh, ex parte Secretary of State for Home Department [1992] ECR I-04265; Case C-148/91 Vereniging Veronica Omroep Organisatie v Commissariaat voor de Media [1993] ECR I-00487; Case C-23/93 TV10 SA v Commissariaat voor de Media [1994] ECR I-04795; Joined cases C-34/95, C-35/95 and C-36/95 Konsumentombudsmannen (KO) v De Agostini (Svenska) Förlag AB (C-34/95) and TV-Shop i Sverige AB (C-35/95 and C-36/95) [1997] ECR I-03843.

⁸⁴ Case Gilly, note supra 20.

45. As the Commission rightly observed, such compensatory tax arrangements prejudice the very foundations of the single market.⁸⁶

The reasoning shows that the ECJ does not accept the argument of lower taxation in another Member State, at least in discrimination cases. Likewise, this argument would also not be accepted as valid justification in cases of abuse and shopping for the most favourable tax jurisdiction. First, cases of shopping for tax jurisdiction will necessarily entail discrimination against a company coming from another Member State. In a purely domestic situation, it is not possible to shop for a more favourable tax jurisdiction because of the unity of the tax system *per se*. Furthermore, according to para. 45 of the decision the ECJ views the single market as a unified market without borders where Member States mutually recognise each other's tax systems. Developing and summarising this argument, similarly to the findings in *Centros* and *Inspire Art* (where the ECJ stated that the choice of most favourable company law jurisdiction is inherent in the single market), the ECJ considers that the choice of the most favourable tax regime is likewise inherent in the EC Treaty.

The conclusions of the ECJ in *Centros*, *Inspire Art*, and *Eurowings* are directly attributable to the concept of 'beneficial owner' and authorisation to apply anti-abuse measures in the Interest-Royalties Directive. Are the same principles applicable here? Can the differences in tax laws be exploited in the same way? Can EU nationals, both individuals and legal entities, exercise their freedom of establishment undisturbed to benefit from differences in the tax systems of Member States? Or should the concept of 'beneficial owner' be interpreted broadly so that Member States are allowed to disregard entities interposed in a more favourable tax jurisdiction? What are the consequences where somebody from outside the EU is taking advantage of the restrictive interpretation of the concept and anti-abuse clauses of the Interest-Royalties Directive? The answers to these questions are essential for implementation of the provisions of the Interest-Royalties Directive in practice, as taxpayers will immediately attempt (and are possibly already attempting) to use favourable EC law for the benefit of minimising the tax burden.

Before interpreting the provisions of the Interest-Royalties Directive in question, it is appropriate to summarise the principles elaborated by the ECJ on the interpretation of measures designed to prevent tax abuse and avoidance addressed in this chapter. The above analysis of case law shows that in the sphere

⁸⁵ Case Asscher, note supra 48.

of direct taxation the challenged measure claimed to be necessary to prevent tax avoidance:

- 1) may be held justified by reasons of pressing public interest and is recognised as a valid justification;
- 2) will be dismissed if national provision constitutes a general prohibition excluding the whole range of situations from the benefits of EC law;
- 3) will be dismissed if not proportional and it is possible to prevent tax avoidance or evasion by other means;
- 4) may be dismissed because it is not designed to exclude 'purely artificial arrangements' only.

These principles developed by jurisprudence in the direct taxation field form the basis for interpretation of the notion of 'beneficial owner' in the Interest-Royalties Directive. The other important principle is stated by the *Centros*, *Inspire Art*, and *Eurowings* cases: these judgements declare that EC nationals are entitled to use the freedom of establishment to shop for a more favourable company law environment. The judgement in *Eurowings* implicitly validated shopping for a more favourable tax law environment.

4. Beneficial ownership provision in the Interest-Royalties Directive

This section deals with interpreting the concept of 'beneficial owner' in the Interest-Royalties Directive by applying the principles developed previously. It begins with some general remarks focusing on a restrictive approach to the interpretation of the concept and proportionality. Then it addresses the scope of the concept of 'beneficial owner' for companies and permanent establishments respectively. Emphasis is placed on issues of interpretation of the concept for companies as this poses most questions. The definition of a company as a 'beneficial owner' is interpreted by reference to the wording of the definition and then by reference to the objectives of the Interest-Royalties Directive and the spirit of the EC Treaty. The paper also touches upon the potential impact of proposed amendments to the Interest-Royalties Directive on interpretation of the concept and briefly notes the issue of improper use of EC law by third country

⁸⁶ Case *Eurowings*, note supra 48, paras. 44-45.

nationals. The analysis leads to final conclusions on the scope of definition of 'beneficial ownership' for companies and permanent establishments.

4.1. General remarks

The concept of 'beneficial owner' allows refusal of application of EC tax benefits to an otherwise qualifying company or permanent establishment situated in an EU Member State. Together with Article 5 of the Interest-Royalties Directive authorising Member States to apply measures to prevent fraud or abuse, the concept constitutes derogation from the general rule of availability of tax benefits.

Following the principle established in *Denkavit*⁸⁷, where derogations were declared to be interpreted narrowly, this concept most probably will also be interpreted narrowly by the ECJ. As demonstrated in the previous section, the ECJ has stated that interpretation of derogations should go beyond the actual wording of the provision.⁸⁸ Accordingly, interpretation of the definition of 'beneficial owner' should not go beyond the actual wording of the relevant provisions of Article 1 of the Interest-Royalties Directive. The permissible scope of the actual wording of the concept for companies and for permanent establishments is explained below.

Simultaneously, following the principles developed by the ECJ in examining the compatibility of Member States' measures for prevention of tax avoidance in general, application of the definition of 'beneficial owner' should satisfy the requirements of proportionality. That is, the application of the 'beneficial ownership' definition should not go further than necessary for achieving the aim pursued. If the ECJ is asked to interpret the definition, then the proportionality requirement will mean that the ECJ will thoroughly examine the circumstances of each particular refusal to apply tax benefits on the basis that the recipient is not the 'beneficial owner' of income.

As identified in the preceding section, the ECJ usually does not accept measures of a general nature excluding the whole range of situations from the benefits of EC law. Thus, where a Member State extends the definition, then that extension could be ruled out on the grounds of non-compliance with proportionality. Moreover, where the definition is not extended by national law but is interpreted too broadly, the ECJ would presumably concentrate on the

⁸⁷ Case *Denkavit*, note supra 65.

factual circumstances by going deep into detail. It should be taken into account that restrictive measures denying benefits of EC tax law rarely pass the proportionality test developed by the ECJ.⁸⁹

4.2. Company as ‘beneficial owner’

4.2.1. Interpretation of definition based on its wording

Article 1(4) of the Interest-Royalties Directive states that a company is a ‘beneficial owner’ if it receives payment for its own benefit and not for some other person as intermediary, such as an agent, trustee, or authorised signatory. Although the word ‘intermediary’ allows for broader interpretation, the examples given in the definition itself clearly restrict the scope of possible intermediaries. Only agents, trustees, or authorised signatories are persons acting in a strictly fiduciary capacity.

In common law countries, this notion will allow disregard of formal owners of income, such as trustees or nominees, who under an agreement with the beneficiaries receive the income for the benefit of those beneficiaries. These persons under the constructions authorised by law are acting in a strictly fiduciary capacity and therefore are not beneficial owners of the income.

In civil law countries, where trusts are not commonly accepted, the definition extends to persons acting only in a fiduciary capacity as well. Though trustees and nominees are not excluded, in civil law countries the ‘beneficial owner’ concept excludes mainly agents who collect income on behalf of another person. Those persons who are legally the sole owners of income and have the rights pertaining to ownership should be included in the list of beneficial owners. Thus, companies interposed between the payer of the income and the ultimate recipient - where these companies are full owners of income enjoying all rights of ownership - cannot be regarded as ‘intermediaries’ in the sense of the definition. These companies are not agents, trustees, or nominees but the full owners of income. In this way, the interpretation for civil law countries may be more limited than in common law countries. In civil law countries, the interpretation of the ‘beneficial ownership’ concept is close to the interpretation of the term

⁸⁸ See Part 3 Section 3.2. above.

⁸⁹ See Part 3.

'beneficial owner' given by the Dutch Supreme Court in its decision of 6 April 1994⁹⁰ discussed in Part 2 above.

It may be argued that the word 'intermediary' still permits broader interpretation. Indeed, this is strengthened by the requirement that a company should receive income for 'its own benefit'. Where a company is the owner of income but effectively acts as a conduit, then it may be treated as an intermediary that does not receive income for its own benefit. However, based on the principle developed by the ECJ - stating that interpretation of derogations should not go beyond the actual wording - it should be admitted that such interpretation goes beyond the actual wording of the definition as a whole. This interpretation ignores the examples and the boundaries introduced by the examples. Furthermore, it will be demonstrated that such broad interpretation fails to comply with the objectives of the Interest-Royalties Directive.

Based on the very wording of the definition and on the examples lacking the beneficial ownership element enumerated in Article 1(4) of the Interest-Royalties Directive, it is concluded that the definition of 'beneficial owner' excludes only persons acting strictly in a fiduciary capacity, such as agents, trustees, or nominees. Intermediaries that have the sole and complete right of ownership may not be denied access to the benefits of the Directive on the basis of the 'beneficial ownership' concept, despite the fact that the income may be transmitted further.

4.2.2. Contextual interpretation in the light of the aims and objectives of the Directive

The main objective of the Interest-Royalties Directive is to eliminate taxation of cross-border interest and royalty payments. The general objective of creation of a single market both in the EC Treaty and the Directive are decisive for interpreting the concept.

First, the principal aim of the Interest-Royalties Directive is to ensure the same favourable tax conditions for cross-border transactions giving rise to interest and royalty payments as for similar domestic transactions. Recital (1) of the Directive essentially states this aim, stressing that the single market has the characteristics of the domestic market. The objective means that the Interest-Royalties Directive strives to create similar conditions for cross-border interest and royalty payments to those existing in the domestic market. As for

⁹⁰ Note supra 27.

interpretation of the concept of ‘beneficial owner’, this aim does not allow the concept to be broadly interpreted. Within the domestic markets and in purely internal situations, there is traditionally no need to reject tax benefits and combat the use of so called ‘conduit companies’, as the income will be subject to tax in the state anyway. Within the domestic market, it is essential to determine the person in whose hands the income will be eventually subject to tax in accordance with the laws of that state. Thus, companies transmitting income to another person as agents, trustees, and nominees and acting in a purely fiduciary capacity will be excluded, while the legal owners of income will be subject to tax. The aim of creating domestic tax conditions for cross-border interest and royalty payments means that the same domestic treatment should be applied in cross-border situations. In the domestic environment, persons acting in a strictly fiduciary capacity are regarded as the owners of income. Consequently, the concept of ‘beneficial owner’ should be interpreted restrictively and cannot be extended by Member States so as to allow disregard of companies interposed with the aim of making use of a more favourable tax regime of another Member State.

Secondly, the purpose of ‘domestic treatment’ of cross-border interest and royalty payments of the Interest-Royalties Directive corresponds to the wider aim of creating a single market. In accordance with Articles 2 and 3(1) c) of the EC Treaty, the activities of the Community include “an internal market characterised by the abolition, as between Member States, of obstacles to the free movement of goods, persons, services and capital”. This aim is also found in Article 3(2) of the draft European Constitution stating, *inter alia*, that the Union shall offer its citizens a single market where competition is free and undistorted. The aim of creating a single market confirms the restrictive interpretation of the ‘beneficial owner’ concept. By its judgements in the *Centros*⁹¹, *Eurowings*⁹², and *Inspire Art*⁹³ cases discussed in detail in section III above⁹⁴, the ECJ seems to promote the creation of a genuine single market founded on the mutual recognition of tax and company laws of the Member States. In these cases, the ECJ explicitly supports the freedom of EU citizens to make use of the “competition of legal orders” and states that such exploitation is inherent in the EC Treaty freedoms.⁹⁵ With respect to the general anti-abuse clause in the Parent-Subsidiary Directive, it was

⁹¹ Case *Centros*, note supra 76.

⁹² Case *Eurowings*, note supra 48.

⁹³ Case *Inspire Art*, note supra 77.

⁹⁴ See Part 3 Section 3.2. above.

proposed that “it is strange, however, from the ‘fundamental freedoms’ viewpoint to look at establishing in a low-tax EU country as fraudulent”.⁹⁶ The same is true in respect of the ‘beneficial ownership’ clause of the Interest-Royalties Directive. This clause cannot restrict the freedom of EU citizens to make use of the more favourable tax regime of a Member State. The argument of prevention of tax avoidance or low taxation in another Member State amounts to non-recognition of the tax system of the other Member State. These arguments will not be accepted by the ECJ in support of an extended interpretation of the ‘beneficial ownership’ concept. Therefore, denial of EC tax benefits on interest and royalties is not possible under the beneficial ownership concept where a company is interposed in a more favourable tax jurisdiction with the purpose of benefiting from that favourable regime.

Accordingly, if the definition is interpreted taking into consideration the aims of the Interest-Royalties Directive and in the light of the EC Treaty, then it should be interpreted restrictively so that situations where interposed companies are used fall outside the scope of definition.

4.2.3. Anti-abuse provisions and their relation to beneficial ownership

Article 5 of the Interest-Royalties Directive explicitly authorises Member States to apply provisions required for prevention of fraud and abuse and to deny the benefits of the Directive when one of the principle motives of transaction is tax avoidance and abuse.⁹⁷ Recital (6) confirms that it is necessary not to preclude Member States from taking appropriate measures to combat fraud or abuse.

Such extensive anti-abuse provisions in the Directive may lead to the conclusion that Member States are authorised to take measures that would result in denial of benefits under the Directive if these measures are applied either in conjunction with the ‘beneficial ownership’ concept or separately. However, it is submitted that these anti-abuse provisions may not be used to broaden the definition of ‘beneficial owner’. Moreover, when applied separately Member State measures on the basis of Article 5 still have to comply with EC Treaty freedoms and the proportionality test.

⁹⁵ Case Centros, note supra 76, para. 27; Case Eurowings, note supra 48, paras.44 and 45; Case Inspire Art, note supra 77, para. 138, all discussed in detail in Part 3 Section 3.2. above.

⁹⁶ C.Brokelind “The proposed Amendments to the Parent-Subsidiary Directive: Some Progress?” 43 European Taxation 12 (2003), p. 456.

⁹⁷ For the precise text of Article 5 of the Interest-Royalties Directive see Part 1.

With regard to the general anti-abuse provisions in conjunction with the ‘beneficial ownership’ notion, this set of rules cannot authorise broader interpretation of the concept. In *Denkavit*⁹⁸, the ECJ rejected the argument of the German government that interpretation of a specific anti-abuse measure was supported by general anti-abuse provisions. The decision discussed the provision of the Parent-Subsidiary Directive constituting derogation from the principle of tax exemption. The German government argued that the derogation in question may be supported by Article 1(2) of the directive providing that it “shall not preclude the application of domestic or agreement-based provisions required for the prevention of fraud and abuse”. With respect to this argument, the ECJ stated:

It is to be noted that Article 1(2) of the Directive is a provision of principle, the content of which is explained in detail in Article 3(2) thereof.⁹⁹

From this interpretation it follows that Member States cannot rely upon general anti-abuse provisions if the situation is already governed by a specific anti-abuse provision or, in the words of legal method, *lex specialis derogat lex generali*.¹⁰⁰ As the situation with general anti-abuse provisions in the Interest-Royalties Directive and the concept of ‘beneficial owner’ is very much similar to the situation decided by the ECJ with regard to the Parent-Subsidiary Directive, then the same principles apply. Therefore, Member States are not authorised to rely on general anti-abuse provisions to support interpretation of a specific anti-abuse provision. More specifically, Article 5 of the Interest-Royalties Directive cannot be relied on to support a broad interpretation of the definition of ‘beneficial owner’.

The issue of the use of general anti-abuse provisions separately from the provisions on ‘beneficial owner’ falls outside the scope of this research. Nevertheless, it is possible to make some observations on the basis of the previous analysis of case law and the objectives of the Interest-Royalties Directive. The objective of domestic tax treatment of cross-border payments of interest and royalties and the aim of creating a single market imply that general measures taken by Member States to prevent fraud and abuse will be examined by the ECJ in the light of these objectives. The *Centros*,¹⁰¹ *Eurowings*¹⁰², and *Inspire Art*¹⁰³ cases illustrate that shopping for the most favourable company law and

⁹⁸ Case *Denkavit*, note supra 65.

⁹⁹ *Ibid*, para.31.

¹⁰⁰ Supported also by B.Terra, P.Wattel note supra 45, p. 365.

¹⁰¹ Case *Centros*, note supra 76.

¹⁰² Case *Eurowings*, note supra 48.

¹⁰³ Case *Inspire Art*, note supra 77.

possibly also tax law jurisdiction is inherent in the single market and EC Treaty freedoms. In *Leur Bloem*,¹⁰⁴ general anti-abuse provisions of the Merger Directive analogous to those of the Interest-Royalties Directive did not save the denial of tax benefits by the Member State from condemnation by the ECJ. It was suggested that these general anti-abuse provisions in the Parent-Subsidiary Directive and the Merger Directive do not discern much value in view of the principles of interpretation developed by the ECJ.¹⁰⁵ As general anti-abuse provisions of these directives are very similar to those of the Interest-Royalties Directive, then the same is true of Article 5 of the Interest-Royalties Directive.

A final observation should be made as regards interpretation of anti-abuse provisions in Article 5 of the Interest-Royalties Directive and the use of EC law by third country nationals. The EC Treaty and thus also EC directives adopted pursuant to the EC Treaty were designed to facilitate a single market as between Member States.¹⁰⁶ This means that third country nationals may not be allowed to use the benefits of the single market when such use amounts to abuse. The use of EC law by third country residents via interposed entities established in the EU to obtain tax benefits that would not be available directly may be reasonably treated as impermissible. Therefore, although these situations will involve questions of EC law and questions of application of tax benefits to EC companies under the Interest-Royalties Directive, it is logical that Member States should be granted more freedom of action than in pure intra-Community situations. Situations involving third-country residents can be decided on the basis of national or agreement-based provisions to prevent tax avoidance. These provisions need not be tested as to compliance with EC law because the matter concerns direct taxation issues, where the Community has no external competence.

To conclude, the definition of ‘beneficial owner’ as a specific anti-abuse measure cannot be extended by interpretation in conjunction with general anti-abuse provisions in Article 5 of the Interest-Royalties Directive. ECJ case law proves that, where both general and specific anti-abuse provisions are present, the principle of *lex specialis derogat lex generali* applies. Further, it is highly questionable whether the use of conduits may be restricted by Member States using Article 5 of the Directive separately. Application of these anti-abuse

¹⁰⁴ Case *Leur Bloem*, note supra 57, discussed in detail in Part 3 Section 3.2. above.

¹⁰⁵ B.Terra, P.Wattel note supra 45, p. 369.

¹⁰⁶ Article 3(1) c) of the EC Treaty.

measures will normally be assessed in the light of the objectives of the Interest-Royalties Directive and the EC Treaty as well as the proportionality requirement. Following the ECJ's findings in *Centros*, *Eurowings*, and *Inspire Art*, it is suggested that shopping for the most favourable tax regime is allowed under EC law and anti-abuse provisions cannot be used by the Member States extensively. It is furthermore concluded that Member States are allowed to apply national or agreement-based anti-abuse provisions in full to deny EC tax benefits under the Interest-Royalties Directive where EC law is abused by third country residents.

4.3. Permanent establishment as a 'beneficial owner'

The definition of permanent establishment as a 'beneficial owner' generally does not raise any specific questions of interpretation. The definition requires that the debt-claim or intellectual property in respect of which interest or royalty arise are effectively connected with that permanent establishment and the income is subject to tax. These requirements differ from the definition of 'beneficial owner' in respect of companies and mainly represent requirements of a technical nature.

The difference in definitions for companies and permanent establishments was noticed and it was proposed that this uncertainty "may lead to a difference in treatment of [permanent establishments] versus subsidiaries" because "the drafters of the Directive defined the concept of 'beneficial owner' differently in the case of a company ... and a permanent establishment of a company of another Member State".¹⁰⁷ However, since a permanent establishment is only a part of a company, the term 'effectively connected' satisfies the needs of the drafters of the Directive. This term requires examination of the factual circumstances of the case and determination of an 'effective connection', thus ensuring that permanent establishments in question are the ultimate economic owners of the payment and are eligible for tax benefits. On the whole, this requirement seems to be rather reasonable because it takes into account the fact that a permanent establishment is only a part of a company situated in another Member State. Consequently, in contrast to the definition of 'beneficial owner' for companies, the condition of 'effectively connected' in the definition of permanent establishments does not involve substantial interpretative issues.

¹⁰⁷ M. Distaso, R. Russo, note supra 19, p. 149.

The second requirement is the ‘subject to tax’ requirement. This requirement constitutes a considerable difference from the definition of ‘beneficial owner’ for companies, which currently does not contain a similar requirement. Under Article 3(a) (iii) of the Interest-Royalties Directive, qualifying companies should in general be subject to any of the taxes listed in the Article without being exempt, whereas the definition of ‘beneficial owner’ for permanent establishments requires imposition of tax specifically on interest or royalty received. This may lead to different treatment of companies and permanent establishments. It is expected that this uncertainty will be removed when the proposal amending the Interest-Royalties Directive¹⁰⁸ is adopted by the Council. After amendments are adopted, Article 1(1) of the Directive will contain a general clause stipulating that tax exemptions under the Directive shall apply only when the beneficial owner of interest or royalties is effectively subject to tax on this particular type of income. This amendment will ensure that the recipient of income - whether a permanent establishment or a company - is eligible for tax exemptions only where it is effectively subject to tax on interest or royalties received.

Therefore, the ‘beneficial ownership’ definition for permanent establishments refers to a test of ‘effective connection’, which is clear and involves examination of the particular circumstances of each case. The second requirement of ‘subject to tax’ on interest or royalty income received may cause differences in treatment between companies and permanent establishments receiving interest or royalty payments. It is expected that this inconsistency will be removed with the adoption of the amendments to the Interest-Royalties Directive.

4.4. Draft amendments to the Interest-Royalties Directive

The draft amendments to the Interest-Royalties Directive¹⁰⁹ do not propose any changes to the definition of beneficial ownership for companies or permanent establishments in Article 1(4) and (5). However, as already stated the amendments modify the text of Article 1(1) of the Directive, essentially by introducing the ‘subject to tax’ requirement for companies or permanent establishments in order to qualify for tax exemption under the Directive. More specifically, tax benefits will be available only when an otherwise qualifying

¹⁰⁸ COM (2003) 841 final; note supra 9.

company or permanent establishment will be effectively subject to tax on interest or royalty income received.

The introduction of the ‘subject to tax’ requirement is explained by the Commission in the Explanatory Memorandum to the proposal as necessary for the reasons that “there should be no loopholes in the provisions of the Directive allowing for circumvention of taxation of interest and royalty payments”.¹¹⁰ The amendment will introduce a substantive provision ensuring that Recital (3) of the Directive providing that “it is necessary to ensure that interest and royalty payments are subject to tax once in a Member State” and Recital (6) of the Directive providing that “it is moreover necessary not to preclude Member States from taking appropriate measures to combat fraud or abuse” are operative.

The texts of both the proposed amendment and the Explanatory Memorandum point out that the amendment will introduce an additional specific anti-abuse provision to the Interest-Royalties Directive. As argued above, the ECJ tends to restrict application of general provisions to prevent tax abuse or evasion if it is already covered by a specific anti-abuse provision.¹¹¹ Consequently, with the adoption of an additional specific anti-abuse provision the freedom of action of Member States to broaden the scope of the ‘beneficial ownership’ concept or to take measures on the basis of general anti-abuse provisions in Article 5 of the Directive will be even more restricted.

This conclusion is supported by the fact that the amendments strive to strengthen the principle of mutual recognition of tax systems by Member States and thus limit Member States’ discretion to refer to low taxation and tax abuse. In other words, a Member State’s discretion to take action to prevent tax avoidance or evasion will become more limited if income is effectively subject to tax in the other Member State even when the tax is considered to be excessively low by the first Member State. The amendment will also have a ‘side effect’ of narrowing the range of available justifications to defend denial of benefits, such as low tax in the other Member State. In this way, while ensuring that interest or royalties are subject to tax once in a Member State, adoption of the proposed amendments will reinforce the principle of mutual recognition and will effectively limit the discretion of Member States to take anti-abuse measures.

¹⁰⁹ Ibid.

¹¹⁰ Ibid, para.3 of the Explanatory Memorandum.

¹¹¹ See discussion of Denkavit case in Section 2.3. of this Part above.

Accordingly, the proposal to amend the Interest-Royalties Directive introduces an additional specific anti-abuse measure and restricts the possibility to widen the interpretation of the concept of 'beneficial owner'. By promoting the mutual recognition of tax systems, it substantially restricts the discretion of Member States to take measures on the basis of the general anti-abuse provisions of Article 5 of the Interest-Royalties Directive. It is likely that in the result the freedom of Member States to take measures to prevent fraud and abuse will be very much confined solely to enforcement of the specific anti abuse rules already present in the Interest-Royalties Directive.

Conclusions

The scope of the concept of 'beneficial owner' in international tax law is not clear. The concept can be interpreted narrowly in such a way that tax benefits can be denied only to entities acting in a strictly fiduciary capacity, such as agents, trustees, or nominees. The concept may also permit a broader interpretation in such a way that tax benefits can be denied to entities that are legal owners of income but are interposed between the payer of income and its ultimate recipient with the purpose of obtaining more favourable tax treatment. Although there is a need to interpret this international tax concept in a uniform manner, there is no agreement as to the precise scope of the concept. There are court decisions from different countries supporting a narrow as well as a broad interpretation.

The concept of 'beneficial owner' in the Interest-Royalties Directive derives its roots from international tax law. From the wording of the definition, it is clear that it is defined based on the non-binding explanation in the OECD Model Convention Commentary. In contrast to international tax law, where there is no common authority to deliver a binding interpretation for all the states involved, in accordance with the doctrine developed by the ECJ the concept of 'beneficial ownership' is to be interpreted uniformly in all EU Member States. Hence, in accordance with the methods of interpretation employed by the ECJ, the definition constitutes an autonomous Community concept the exact scope of which is to be determined in the light of its wording, the objectives of the Interest-Royalties Directive, and the spirit of the EC Treaty.

Interpretation of the concept by reference to its wording, the objectives of the Interest-Royalties Directive, and the spirit of the EC Treaty reveals that it is

to be interpreted restrictively. The restrictive interpretation excludes only persons acting strictly in a fiduciary capacity, such as agents, trustees or nominees, from the application of tax benefits under the Interest-Royalties Directive. Intermediaries that have the sole and complete right of ownership of the income, despite the fact that it may be transmitted further, cannot be denied access to the benefits of the Directive under the ‘beneficial ownership’ concept. This conclusion is built on the following arguments.

First, the definition of ‘beneficial owner’ derogates from the general principle of tax exemption of interest or royalty payments in the state of source. Pursuant to the doctrine developed by the ECJ in *Denkavit*, derogations from a general tax exemption regime are to be interpreted restrictively, not going beyond the actual wording of the provision to the detriment of beneficiary undertakings. The actual wording of the definition of ‘beneficial owner’ for companies, and the examples lacking a beneficial ownership element listed in the definition itself, exclude only persons acting strictly in a fiduciary capacity. The wording excludes only agents, trustees or nominees and does not permit refusal of tax benefits to a wider range of persons.

Secondly, the aim of domestic tax treatment for cross-border interest and royalty payments stated in Recital (4) means that domestic treatment should be applied to cross-border payments of interest and royalties. Within the domestic markets there is normally no need to reject tax benefits and combat the use of so-called ‘conduit companies’ as the income will be subject to tax in the state anyway. Consequently, based on the objective of domestic treatment for cross-border interest or royalty payment, the concept of ‘beneficial owner’ should be interpreted restrictively in a way that recognises full legal owners of income as ‘beneficial owners’.

The restrictive interpretation is furthermore supported by the general aim of creating a single market stipulated in Article 3(1) c) of the EC Treaty, where obstacles to the free movement of goods, persons, services, and capital are abolished between the Member States. The judgements in *Centros*¹¹², *Eurowings*¹¹³ and *Inspire Art*¹¹⁴ confirm the promotion of a genuine single market founded on the mutual recognition of tax and company laws of the Member States. These cases demonstrate that the freedom of EU citizens to make use of

¹¹² Case *Centros*, note supra 76.

¹¹³ Case *Eurowings*, note supra 48.

¹¹⁴ Case *Inspire Art*, note supra 77.

the “competition of legal orders” and exploitation of such competition is inherent in the EC Treaty. Thus, the use of companies established in a more favourable tax jurisdiction is inherent in the EC Treaty. Consequently, if the definition is interpreted taking into consideration the aims of the Interest-Royalties Directive and in the light of the EC Treaty, then it should be interpreted restrictively so that situations where so-called ‘conduit companies’ are used fall outside the scope of the ‘beneficial ownership’ test.

It is also concluded that the scope of the concept for permanent establishments is clear. It does not permit a broad interpretation and should not involve any significant interpretative issues.

Finally, draft amendments to the Interest-Royalties Directive, if adopted, will reinforce the restrictive reading of the notion of ‘beneficial owner’. The amendments will introduce an additional specific anti-abuse measure and as a result will further limit Member States’ discretion to enforce anti-abuse measures in general.