

An Italian Perspective on the Concept of Beneficial Ownership

by Marco Rossi

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Marco Rossi is the founder and principal of Marco Q. Rossi & Associati in New York. E-mail: mrossi@lawrossi.com

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I. Introduction

Under Italian tax law, the concept of beneficial owner of income applies in four main areas: tax treaties, the EU interest and royalties directive,¹ the EU savings tax directive,² and the domestic portfolio income exemption.

Tax treaties limit the power of a contracting state to tax dividends, interest, and royalties arising in that state and paid to a resident of the other contracting state by reducing or eliminating the tax that can be charged by the first state. With few exceptions, Italian tax treaties provide that relief from tax on Italian-source dividends, interest, and royalties applies only if the recipient of the income, or the person claiming the treaty benefits, in addition to being a resident of the other contracting state, is also the beneficial owner of the income concerned.

The EU directive on interest and royalties exempts interest and royalty payments between associated companies of EU member states (or between their permanent establishments located in an EU member state) from tax in the state in which the payment arises. The exemption applies if the company (or its PE) claiming the benefit is the beneficial owner of the payment.

¹Council Directive 2003/49/EC of June 3, 2003, which had to be implemented in all member states by January 1, 2004, and was implemented in Italy with Legislative Decree No. 143 of May 30, 2005.

²Council Directive 2003/48/EC of June 3, 2003, implemented in Italy with Legislative Decree No. 84 of Apr. 18, 2005.

The EU directive on taxation of savings income provides for a system of exchange of information between EU member states that ensures that an individual resident in a member state is taxed in his state of residence on savings income in the form of interest earned from another member state. The directive applies if the individual receiving the income, being a resident of a member state, is also the beneficial owner of the income.

Finally, domestic tax law exempts nonresident taxpayers from taxation in Italy of specific items of Italian-source portfolio income. The exemption applies to foreign persons who are residents of approved countries (those that allow exchange of information with Italy and are on a special list), if they are the beneficial owners of the income for which the exemption is claimed.

Neither the Italian tax treaties in force (with only one exception) nor the OECD model tax treaty contains a definition of beneficial owner.

In the absence of a definition in tax treaties, the term “beneficial owner” should be interpreted in accordance with the domestic law of the country that applies the treaty (that is, the source country), as provided for under the typical tax treaty article 3(2).

Italian tax law does not contain a definition of beneficial owner for general tax or treaty purposes. Beneficial owner is defined and used in other specific areas of Italian law, and the definition in those areas may affect the interpretation of that same term as it applies in tax treaties.

The EU interest and royalties directive provides a definition of beneficial owner, since it applies when exempting interest and royalties paid between EU associated companies. Italian implementing legislation has transposed that definition to domestic law. Italian tax authorities have provided guidance on the interpretation and application of the term for purposes of the directive in Ministerial Circular No. 47/E of 2006.

The purpose of the beneficial ownership provision in the EU interest and royalties directive is very similar to that of the beneficial ownership clause in tax treaties. In both cases, the term is used to avoid abuses of conduit or legal artificial structures to benefit from a tax exemption or reduction afforded by the law that otherwise would not apply.

Therefore, the definition of beneficial owner in the EU interest and royalties directive is likely to play an important role for the interpretation of that same term as used and applied in tax treaties.

The EU savings directive and the Italian domestic provisions on the portfolio income exemption for nonresident taxpayers have their own definitions of beneficial owner. Therefore, they also can offer guidance for the interpretation of the term as used and applied in tax treaties.

Moreover, Italian tax authorities generally rely on the commentary to the OECD model treaty and tax cases decided in other jurisdictions to define international tax concepts and treaty terms and address international tax issues.

The commentary to the OECD model as revised in 2010 provides important clarifications on the interpretation of the term “beneficial owner” in tax treaties.

The OECD commentary links the concept of beneficial ownership to possible abuses of tax treaties and suggests that the beneficial ownership provision should be used to deny treaty benefits (in the form of elimination or reduction of source-based withholding taxes on portfolio income such as dividends, interest, and royalties) when non-treaty-country taxpayers who would not be eligible for the treaty benefits try to achieve them through legal arrangements that are perceived as abusive or artificial.

In particular, according to the OECD commentary, the beneficial owner requirement targets conduit or back-to-back investments or financing arrangements that purport to channel portfolio income payments through intermediate entities established in treaty countries so that taxpayers can claim a reduction or elimination of source-based withholding tax on those payments, which otherwise would not be due (had the transaction been consummated directly between the original payer and the final payee of the income).

Given the risks of double taxation and nontaxation resulting from different interpretations of the concept of beneficial owner by courts and tax administrations, Working Party 1 of the OECD Committee on Fiscal Affairs recently worked on proposals designed to clarify the interpretation of that concept in the OECD model. Therefore, on October 19, 2012, the OECD released a revised discussion draft on the meaning of beneficial owner in articles 10, 11, and 12 of the OECD model.³ The revised discussion draft came on the heels of the OECD’s April 29, 2011, discussion draft,⁴ which was widely criticized by the tax community as being confusing and overly broad in its application.

Finally, since the beneficial owner requirement is applied as an antiavoidance provision, it interacts with domestic statutory antiabuse measures or judicial doctrines designed to prevent or eliminate similar abuses outside of tax treaties. In view of this interaction, the way in which those antiabuse provisions are interpreted

³OECD, “Revised Proposals concerning the Meaning of Beneficial Owner in Articles 10, 11 and 12 of the OECD Model Tax Convention Revised Public Discussion Draft” (2012).

⁴OECD, “Clarification of the Meaning of ‘Beneficial Owner’ in the OECD Model Tax Convention Public Discussion Draft” (2011).

is also important and likely to be referred to for determining the exact scope and meaning of the treaty's beneficial owner requirement.

Recently, the Italian tax authorities and courts have moved from a formalistic approach, which focused primarily on the legal form of a transaction to determine its tax consequences, to a substance-over-form method, according to which the tax treatment of a transaction is dictated by its real juridical and economic substance. In pursuing that new approach, the Italian courts and tax administration often referred to international tax principles and antiabuse doctrines elaborated at the EU tax law level as relevant authorities for domestic tax purposes, too.

The above approach suggests that the Italian tax administration and courts might be willing to interpret the beneficial ownership concept by making reference to its international fiscal meaning and taking into account how the concept has been interpreted and applied by courts in other jurisdictions, and using it as a broad antiavoidance measure.

Some judicial decisions — like the one issued by the U.K. Court of Appeal in the *Indofood* case⁵ — are likely to offer further support for tax authorities and courts that want to pursue a substance-over-form analysis, and challenge, under the beneficial ownership theory, cross-border contractual arrangements designed to achieve treaty benefits.

As a result, there could be an increasing risk that arrangements that were once considered safe may be under attack, and tax benefits that previously could be taken for granted may be challenged or denied.

However, recent case law seems to move away from the above interpretation of the beneficial owner requirement in treaties, raising further uncertainty in the application of that concept worldwide. The landmark case in this regard is *Prévost Car Inc.*,⁶ which considered the question whether a foreign holding corporation resident in a jurisdiction other than that of its shareholders is the beneficial owner of dividends and therefore entitled to the benefits of the relevant tax treaty. This decision, soundly in favor of taxpayers, dismissed the reasoning of the court of appeal in *Indofood* and stated that the beneficial owner of the dividends was the holding company itself and not the ultimate shareholders of the company. Even with the argument of the tax authorities, the Tax Court of Canada interpreted the beneficial owner test based on the legal ownership of the income. On the question whether a domestic or international meaning should be applied, the ruling seemed relatively clear in determining what the term “beneficial owner” meant by reference to a domestic meaning.

⁵*Indofood International Finance Ltd. v. JPMorgan Chase NA, London Branch* (2006).

⁶*Prévost Car Inc. v. The Queen*, 2008 TCC 231 (Apr. 22, 2008).

This article provides an overview of the concept of beneficial ownership of income from the perspective of international and Italian tax law — as it arises in tax treaties, EU directives, and domestic legislation — and of its interaction with other domestic antiabuse provisions and judicial doctrines.

As we move along with the analysis of the relevant authorities and areas of law, the concept of beneficial ownership emerges as a broad antiabuse provision and involves two fundamental inquiries: whether the taxpayer who claims the treaty benefits has sufficient economic power to receive and dispose of the income for his own direct benefit, based on the legal terms and economic substance of the transaction; and whether he is treated as the owner of the income in his home jurisdiction for tax purposes.

There is an emerging tendency to interpret the term “beneficial owner” according to its international fiscal meaning based on the above-mentioned analysis, going beyond the narrower technical meaning that the term may have under national tax laws.

II. Tax Treaties

A. Italian Tax Treaties (in Force)

1. In General

Italy has 91 tax treaties in force. Most are based on the 1977 OECD model income tax treaty and require that in eliminating or reducing Italian withholding tax on dividends, interest, and royalties paid to a resident of the other contracting state, the taxpayer that is the recipient of the income and invokes the benefits of the treaty, in addition to being a resident of the other contracting state within the meaning of treaty article 4 — that is, subject to tax in its home country based on its residence, domicile, place of management and control, or other criteria of a similar nature — must also be the beneficial owner of the income for which treaty benefits are claimed.

A literal reading of the language of the portfolio income provisions of most Italian tax treaties requires that the person invoking the treaty be both the recipient and beneficial owner of the income. That would mean that the ultimate beneficial owner of the income, who is a resident of the other contracting state but not the immediate recipient of the income, might not be eligible for treaty benefits.

This result would be in contrast with a tax treaty's fundamental purpose of preventing double taxation. To clarify this issue, the text of the OECD model was amended in 1995, and paragraph 12.2 of the current commentary to article 10 of the OECD model makes clear that treaty benefits remain available when an agent or a nominee is interposed between the beneficial owner and the payer of the income — but the beneficial owner is a resident of the contracting state. The commentary acknowledges that that has been the consistent position of all member states.

Almost half of Italy's tax treaties provide in their portfolio income articles that the competent authorities of the contracting states will determine how tax treaty benefits for portfolio income will apply.

2. Germany-Italy Tax Treaty

The Germany-Italy tax treaty is Italy's only treaty that contains a definition of beneficial owner.

The definition is set forth in paragraph 9 of the protocol to the treaty:

9. With reference to Articles 10, 11 and 12:

the recipient of the dividends, interest and royalties is the beneficial owner within the meaning of Articles 10, 11 and 12 if he is *entitled to the right upon which the payments are based* and the income derived there-from is *attributable to him under the tax laws of both States*. [Emphasis added.]

The definition is based on two tests: entitlement to the right upon which payment of income is made (nontax test), and attribution of the income for tax purposes (tax test).

The beneficial owner of income is the person that is entitled to the right upon which the payment is made under general contract law and to which income is attributed for tax purposes under the tax laws of both contracting states.

Consequently, if the transaction is inconsistently characterized under the tax laws of either contracting state, the treaty benefits should not apply.

3. Italy-Turkey Tax Treaty

The protocol to the Italy-Turkey tax treaty⁷ contains a special provision on the beneficial ownership requirement of articles 10, 11, and 12, but only sheds limited light on the meaning of that term.⁸

4. Italy-Switzerland Tax Treaty

The residence article of the Italy-Switzerland tax treaty⁹ contains a provision that denies the status of resident of a contracting state to a person that meets the ordinary residence tests of paragraphs 1-3 of article 4 but is only the apparent recipient of the income, while the person that actually receives the income (also

indirectly, through other individuals or legal entities) does not qualify as a resident under the treaty.¹⁰

The provision uses broad terms and is far-reaching.

It looks at the real (actual) recipient of the income, as opposed to the seeming (immediate) recipient, and targets back-to-back or conduit structures by also making reference to the case when the ultimate income beneficiary receives the income indirectly through other individuals or entities.

Most importantly, unlike the ownership requirement of the treaty's portfolio income articles, the provision has the effect of denying all treaty benefits, as a result of the taxpayer's failing to qualify as a resident of the other contracting state under that special antiabuse rule.

The portfolio income articles of the Italy-Switzerland tax treaty provide for relief from source-country tax on portfolio income if the recipient of dividends, interest, or royalties has a right to their enjoyment.

The term "right to enjoyment" of income is peculiar to this treaty and has no equivalent in the OECD model or commentary.

5. Australia-Italy Tax Treaty

The Australia-Italy tax treaty¹¹ provides relief from source-country withholding tax on portfolio income regarding dividends, interest, or royalties to which a resident of the other contracting state is beneficially entitled.

The term "beneficial entitlement" to income is peculiar to the Australia-Italy treaty and has no equivalent in the OECD model or commentary.

6. Italy-U.S. Tax Treaty

The Joint Committee on Taxation explanation (JCS-30-85, July 29, 1985) on the interest article of the previous Italy-U.S. tax treaty of 1985¹² stated the following:

The lower rate in the proposed treaty applies only if the interest is beneficially owned by a resident

¹⁰See article 4(5):

The following shall be deemed not to be resident in a Contracting State within the meaning of this Article: a. a person who, while fulfilling the conditions laid down in paragraphs 1 to 3 is merely the *seeming recipient* of the income in question whereas the person who *actually receives* the income — either directly or indirectly through other individuals or legal entities — is not deemed to be a resident of that State within the meaning of this Article. [Emphasis added.]

¹¹The treaty was signed Dec. 14, 1982, was ratified via Law No. 292 of May 27, 1985, and entered into force on Nov. 5, 1985.

¹²The treaty was signed in Rome on Nov. 16, 1985, was ratified via Law No. 763 of Dec. 11, 1985, and entered into force on Dec. 30, 1985.

⁷The protocol was signed July 27, 1990, was ratified June 7, 1993, and entered into force on Dec. 1, 1993.

⁸Para. V of the Italy-Turkey treaty protocol reads as follows:

V. Articles 10, 11 and 12: It is understood that the "beneficial owner" clause should be interpreted in the meaning that a third country resident will not be allowed to get benefits from the Tax Agreement with regard to dividends, interest and royalties derived from Turkey or Italy, but this restriction shall in no case be applied to residents of a Contracting State.

⁹Signed Mar. 9, 1976, ratified Dec. 23, 1978, and entered into force on Mar. 27, 1979.

of the other country. Accordingly, it does not apply if the recipient is a nominee for a nonresident.

The same comment was made regarding the royalty article of the treaty.

Identical language was in the Senate Foreign Relations Committee report (S. Exec. Rpt. 99-6, December 11, 1985).

Articles 10, 11, and 12 of the Italy-U.S. treaty currently in force¹³ are identical to the corresponding articles of the 1985 treaty.

The U.S. Treasury Department technical explanation to the current Italy-U.S. treaty (October 27, 1999),¹⁴ whose articles 10-12 are unchanged from the previous treaty, states the following in its comments on article 10:

The term “beneficial owner” is not defined in the Convention, and is, therefore, defined as under the internal law of the country imposing tax (i.e., the source country). The beneficial owner of the dividend for purposes of Article 10 *is the person to which the dividend income is attributable for tax purposes under the laws of the source State*. Thus, if a dividend paid by a corporation that is a resident of one of the States (as determined under Article 4 (Resident)) is received by a nominee or agent that is a resident of the other State on behalf of a person that is not a resident of that other State, the dividend is not entitled to the benefits of this Article. However, a dividend received by a nominee on behalf of a resident of that other State would be entitled to benefits. These limitations are confirmed by paragraph 12 of the OECD Commentaries to Article 10. See also, paragraph 24 of the OECD Commentaries to Article 1 (Personal Scope). [Emphasis added.]

Similar comments are made in the Treasury technical explanation regarding articles 11 (interest) and 12 (royalties).

Article 10(10), article 11(9), and article 12(8) of the current Italy-U.S. treaty contain a general antiabuse provision according to which treaty relief from source-based tax on portfolio income does not apply if the main purpose or one of the main purposes for the creation or assignment of the right for which income is paid is to take advantage of the treaty.

¹³Convention Between the Government of the United States of America and the Government of the Italian Republic for the Avoidance of Double Taxation With Respect to Taxes on Income and the Prevention of Fraud or Fiscal Evasion, signed in Washington on Aug. 25, 1999, ratified via Law 20 of Mar. 3, 2009, and entered into force on Dec. 16, 2009.

¹⁴Signed on Aug. 25, 1999.

7. *Treaties Without the Beneficial Owner Requirement*

Several Italian tax treaties do not contain the beneficial owner requirement.

They include treaties with Cyprus (1974), Hungary (1977), Ireland (1971), Japan (1969 and amended in 1980), Morocco (1972), Tanzania (1973), Thailand (1977), Trinidad and Tobago (1971), Yugoslavia (1982; this applies to Bosnia and Herzegovina, Croatia, Slovenia, Serbia, and Montenegro), and Zambia (1972).

Among them, there are three EU low-tax jurisdictions: Ireland, Cyprus, and Hungary.

In those treaties, benefits are granted regarding dividends, interest, or royalties paid to a resident of the other contracting state.

8. *Treaties Containing Antiabuse (Main Purpose) Clauses*

Italy's tax treaties with Estonia¹⁵ and Lithuania¹⁶ (EU member states) contain general antiabuse (limitation on benefits) provisions, according to which a resident of the contracting state will not receive the benefit of any reduction in or exemption from taxes provided for in the treaty by the other contracting state, if the main purpose or one of the main purposes of the creation or existence of that resident or of any person connected with that resident was to obtain the benefits of the treaty that would not otherwise be available (treaty shopping).¹⁷

Those treaties also contain a savings clause, according to which the provisions of the treaty do not affect the application of domestic provisions of a contracting state concerning the limitation of expenses and deductions from transactions between enterprises of a contracting state and enterprises situated in the other contracting state, if the main purpose or one of the main purposes of the creation of those enterprises or the transactions undertaken between them was treaty shopping.¹⁸

The reference is to Italy's antiabuse provisions on the limitation of deductions set forth in Italian Income Tax Code article 110, paragraph 10. They apply to transactions entered into with enterprises located in low-tax foreign jurisdictions on the blacklist, but unrelated to the domestic enterprise and regardless of the motive of the transactions. Deductions are allowed if the foreign enterprise is engaged in a bona fide active

¹⁵The treaty was signed Mar. 3, 1997, was ratified via Law No. 427 of Oct. 19, 1999, and entered into force on Feb. 22, 2000.

¹⁶The treaty was signed Apr. 4, 1996, was ratified via Law No. 31 of Feb. 9, 1999, and entered into force on June 6, 1999.

¹⁷Article 28(1) of the Estonia-Italy treaty; article 30(1) of the Italy-Lithuania treaty.

¹⁸Article 28(2) of the Estonia-Italy treaty; article 30(2) of the Italy-Lithuania treaty.

trade or business in its state of residence, or the transaction is a bona fide business transaction and has been carried out.¹⁹

Because of the treaty clause, Italy can continue to apply its domestic antiabuse provisions referred to above to transactions between an Italian enterprise and a treaty partner (without incurring a treaty override or violation of the treaty's nondiscrimination provisions), if the main purpose or one of the main purposes of the creation of the treaty partner's enterprise or of entering into that transaction was treaty shopping.

The Italy-U.S. treaty contains antiabuse provisions in its portfolio income articles. They are more limited in scope than a general antiabuse clause. They deny the treaty benefits of reduced withholding tax on dividends, interest, or royalties (not all treaty benefits) if the main purpose or one of the main purposes of the transaction is treaty shopping.

9. Procedural Requirements for Treaty Benefits

Italian payers are authorized to not apply the withholding tax (for treaty exemption) or to charge directly the treaty's lower withholding tax (for treaty reduction of withholding tax).²⁰

For those treaty benefits, Italian payers must collect the following documentation:

- a certificate provided by the tax administration of the other contracting state stating that the person that invokes the benefits of the treaty is resident in the contracting state for purposes of the treaty; and
- a statement provided by the resident of the other contracting state that claims the benefits of the treaty, certifying that it is the beneficial owner of the income under the treaty and does not have a PE in Italy to which the payment is attributable.

A false statement constitutes fraud and can be punished as a crime.

10. Interpretation of 'Beneficial Owner'

In the absence of a definition in the relevant treaty, the term "beneficial owner" should be interpreted under Italy's internal tax law, and in accordance with the treaty's object and purpose (typically under article 3(2) of the treaty).

Italian internal tax law does not provide a definition of beneficial owner for general tax or treaty purposes.

The Italian tax administration recently took the position that the term should be interpreted in accordance

with its international fiscal meaning and the clarifications provided in the commentary to the OECD model, also taking into account the way in which it is interpreted and applied in other jurisdictions.²¹

Italy's tax administration²² and courts²³ have been consistent in maintaining the view that the OECD model and related commentary play an important role in interpreting tax treaties and addressing international tax matters.

The commentary in force at the time a treaty was entered into is likely to play a greater role in the interpretation of that treaty than later versions of the commentary.

However, later versions are also relevant, in general and especially if they are used to clarify the meaning of specific treaty provisions that have not been changed in the meantime.

At the same time, the definition of beneficial owner provided in the EU interest and royalties directive, savings income directive, implementing internal legislation, and domestic provisions on the portfolio income exemption may also play an important role as a means of interpretation of the term that is used and applies in tax treaties.

Finally, considering the general antiabuse function assigned to the beneficial ownership requirement in the treaty, it can be reasonably argued that the term should be interpreted consistently with the meaning in domestic antiavoidance rules.

Below, I discuss all the possible sources of authority for the interpretation of the term "beneficial owner" that are relevant under Italian law.

B. OECD Model and Commentary

1. 1977 Commentary to OECD Model

The beneficial ownership requirement was used for the first time in the 1977 OECD model. It did not define the term "beneficial ownership." The commentary

¹⁹Ruling No. 84/E of July 12, 2006, which is discussed in more detail at Section II.D.2 of this article.

²²See Circular No. 207/E of Nov. 16, 2002 (referring to the commentary to article 3 of the OECD model for the definition of person in applying domestic controlled foreign corporation rules); and Resolution No. 145/E of Sept. 10, 1999 (referring to the commentary to article 17 of the OECD model concerning taxation of the income of artists and athletes).

²³See Italian Supreme Court, Judgment No. 11648 of Sept. 5, 2000 (the Court referred to the commentary to article 7, para. 3, of the OECD model to decide a case concerning the allocation of costs between a head office and its PEs); Supreme Court, judgment nos. 3367 and 3369 of Mar. 7, 2002, and 7689 of May 25, 2002 (the Court referred to the commentary to article 5 of the OECD model to decide a series of cases concerning the existence in Italy of a PE of a foreign company); and Supreme Court, Judgment No. 7851 of Apr. 23, 2004 (the Court referred to the commentary to article 7(2) to decide whether VAT is due on transfers between the head office and its PE).

¹⁹For an overview of Italy's antiabuse rules limiting the deduction of costs incurred in transactions with foreign enterprises organized in blacklisted jurisdictions, see Marco Rossi, "Italy Clarifies Scope of Antiabuse Rule," *Tax Notes Int'l*, July 3, 2006, p. 7.

²⁰See Resolution No. 95/E, issued on June 10, 1999, and Resolution No. 68, issued on May 24, 2000.

to the 1977 model provided only limited guidance on the meaning of the term “beneficial owner.”

The commentary stated that the limitation of tax in the state of source was unavailable when an intermediary, such as an agent or nominee, was interposed between the beneficiary and payer, unless the beneficial owner of the income is a resident of the other contracting state.²⁴

Under Italian internal law, an agent, a nominee, or an intermediary is a person that acts on behalf of and for the account of another person (the principal), so that the transactions or arrangements it enters into are legally binding and juridically affect, directly and exclusively, the principal, or the legal owner of the assets and income from the transaction.

This is not the case when a person (commission agent, or *mandatario*) acts on its own behalf but for the account of another person (principal, or *mandante*) without authority to bind the principal. In that case, the legal effects of the transaction are on the agent and then transferred to the principal under a separate legal relationship.

The agent is the legal owner of the assets or the income from the transaction for general law purposes. For bankruptcy, the agent’s creditors can enforce their claims on the assets or income acquired in the transaction, which is treated as the agent’s personal assets and income.

Therefore, following the commentary’s explanation, in Italian law, the principal as opposed to the agent would be regarded as the beneficial owner only when a person acted with authority to bind and as an agent on behalf of (that is, with legal effects on) the principal.

That is the narrow technical meaning of the term “beneficial owner” under Italian law, following the above approach. A person that contracts or acts on its own behalf, and acquires or holds bare legal title to the property is treated as the beneficial owner of the income from that property.

The fact that that person later transfers the asset or income acquired in the transaction under a back-to-back arrangement with the principal does not matter. Treaty benefits would still be assigned to the agent because it is the legal owner of the income from the transaction.

On the other hand, the commentary to article 1 of the 1977 OECD model enlarged the picture and linked the concept of beneficial ownership to treaty abuse. It observed that taxpayers might try to obtain tax relief under treaties through artificial legal constructions, as would be the case if a person acted through a legal

entity created in a contracting state to obtain treaty benefits that would not be directly available to that person.

The commentary also pointed out that some of those situations are dealt with in the model, for example, by the introduction of the concept of beneficial owner.

That clarification suggested that the beneficial owner concept could be interpreted according to its economic or substantial meaning, and applied as a broader anti-abuse provision in light of the treaty’s overall object and purpose, which includes elimination of double nontaxation.

The subsequent revisions of the commentary are a confirmation of that approach.

2. 1992 Commentary to OECD Model and Conduit Report

The revised commentary released in 1992 made reference to the OECD reports entitled “Double Taxation Conventions and the Use of Base Companies” and “Double Taxation Convention and the Use of Conduit Companies,” issued by the OECD Committee on Fiscal Affairs on November 27, 1986.

The conduit report took a step forward in targeting the use of conduit arrangements to achieve treaty benefits and stated the following regarding the meaning of the beneficial ownership provision for the limitation on treaty benefits:

The provisions would, however, apply also to other cases where a person enters into contracts or takes over obligations under which he has a *similar function* to those of a nominee or an agent. This conduit company can normally not be regarded as the beneficial owner if, although the *formal owner* of certain assets, it has very *narrow powers*, which render it a *mere fiduciary or an administrator* acting on account of the interested parties (most likely the shareholders of the conduit company). [Emphasis added.]

That comment was finally included in the 2003 commentary to the OECD model. (See Section II.B.3 of this article.)

The conduit report suggests a more complex analysis of the beneficial owner concept based on a person’s powers of enjoying and disposing of the income.

The report draws a distinction between the holder of bare legal title to the income, with limited powers of enjoyment or disposition of the income, and the actual owner of the income, enjoying full powers of realization and disposition of the income for his own benefit, and it attributes the status of beneficial owner to the latter.

That approach is at the core of a broader interpretation of the beneficial ownership requirement that emphasizes substance over form and focuses on the economic substance and business purpose of the transaction in determining the person that is eligible for treaty benefits.

²⁴ See para. 12 of the commentary to article 10 of the 1977 OECD model, para. 8 of the commentary to article 11, and para. 4 of the commentary to article 12.

3. 2003 Commentary to OECD Model

The revised commentary to the 2003 OECD model added further comments on the interpretation of the beneficial owner concept based on the above clarifications.

a. General comment. The commentary to the portfolio income provisions of the model treaty provided the following general clarification:

The requirements of beneficial ownership makes plain that the state of source is not obliged to give up taxing rights . . . merely because that income was *immediately received* by a resident of the other contracting state.

The term “beneficial owner” is *not used in a narrow technical sense*, rather, it should be understood in its context and in light of the object and purposes of the Convention, including *avoiding double taxation and the prevention of fiscal evasion and avoidance.*²⁵ [Emphasis added.]

The above comment advances an interpretation of the term “beneficial owner” that focuses on the substance of the transaction and gives that term a wider meaning and scope, as it is intended to apply like a more far-reaching antiabuse clause.

b. The agent, nominee, or intermediary case. Regarding the agent or intermediary case, the commentary stated:

When 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 treaty 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.*²⁶ [Emphasis added.]

According to that clarification, under the beneficial owner requirement, treaty benefits are denied when the immediate recipient of the income acts as an agent or a nominee, and consequently is not treated as the owner of the income and not taxed on the income under the laws of its state of residence.

The commentary focuses on the tax treatment of the recipient of the income in the recipient’s state of residence. The test is whether under the rules of the

recipient’s residence country, the income recipient is treated as the owner of the income for tax purposes and is subject to tax on that income.

When the recipient of the income is not treated as the owner of the income and is not subject to tax on that income under the laws of his state of residence, the recipient should not qualify as beneficial owner and, therefore, should not be eligible for the benefits of the treaty.

As a matter of Italian law, that happens when a person acts on behalf (in the name) of another person so that the legal consequences and effects of a transaction are produced directly upon the latter person, who is treated as the legal owner of the income from the transaction.

In any other case, even though a person may be obliged to pass the income on to its principal under a separate contractual arrangement, that person would be regarded as the owner of the income and would be taxable on that income, and therefore it should qualify as beneficial owner and be entitled to treaty benefits under that narrow technical meaning.

c. The conduit case. Regarding conduits, the commentary stated the following:

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” 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.²⁷ [Emphasis added.]

Contrary to the agent, intermediary, or nominee test, the conduit test is a facts and circumstances test for determining whether a person is the real owner of the income in an economic sense, receiving the income for its own benefit, as opposed to the holder of a bare legal title to the income, with no independent powers of enjoyment and disposition of it, and acting for the account of the real owner and beneficiary of the income.

The inquiry must be conducted based on all the facts and circumstances of the transaction.

The test asks whether, under the laws of the recipient’s state of residence, the recipient — even though it

²⁵ See para. 12 of the commentary to article 10 of the 2003 OECD model, para. 9 to the commentary to article 11, and para. 4 to the commentary to article 12.

²⁶ See para. 12.1 (second and third sentences) of the commentary to article 10 of the 2003 OECD model, para. 10 of the commentary to article 11, and para. 4.1 of the commentary to article 12.

²⁷ See commentary to article 10, para. 12.1 (fourth and fifth sentences) of the 2003 OECD model.

may be treated as the legal owner of the income for tax purposes and taxed on that income — possesses or retains such narrow or limited powers on the income as a result of restrictions or limitations provided for by law or under the terms of its contractual relationship with the final beneficiary of the income that, in fact, it lacks an independent power to realize and dispose of the income based on its own judgment and for its own direct benefit. It also seeks to determine whether, therefore, the recipient ultimately acts in the same way as a fiduciary or administrator for the account and in the interest of another person who is the final income beneficiary regarding the income concerned.

The analysis turns on the facts of the case and terms of the contractual agreement between the immediate recipient and the final beneficiary of the income in question.

The U.K. Court of Appeal relied on the above commentary in referring to the international fiscal meaning of beneficial ownership that it applied in the *Indofood* decision.

4. 2010 Commentary to OECD Model

Changes to the commentary to address the position of collective investment vehicles (CIVs) were included in the 2010 update to the OECD model.²⁸ There was no change to the existing commentary to articles 10, 11, and 12, beyond a reference to the particular issues affecting CIVs, which were addressed in the commentary to article 1. The wide variety of vehicles used as CIVs led to the recognition that states may need to clarify bilaterally the operation of a treaty regarding those vehicles.²⁹

²⁸The new commentary repeated the comments from the “Report of the Informal Consultative Group on the Taxation of Collective Investment Vehicles and Procedures for Tax Relief for Cross-Border Investors on the Granting of Treaty Benefits With Respect to the Income of Collective Investment Vehicles,” OECD Committee on Fiscal Affairs, Apr. 23, 2010. That report addressed the question whether a widely held CIV should properly be regarded as the beneficial owner of the income it derives, assuming that the article 3(2) test in the OECD model for interpreting terms that are not expressly defined applies, with the result that the meaning of beneficial owner is to be decided under the law of the state applying the treaty. It was stated that the investor has the right to receive an amount equal to the value of his allocable share of the underlying assets, but that that right is not the equivalent of receiving the assets as a commercial or tax matter. Based on the fact that the investor has no right to the underlying assets, and also that income from an asset generally cannot be traced to a particular investor, the report concluded that a widely held CIV should be treated as the beneficial owner of the income received, so long as the managers of the vehicle have discretionary powers to manage the assets for the investors (and subject to the vehicle being a “person” and “resident” as required by an applicable treaty). In this regard, particular emphasis was given to the status of the assets held by the CIV.

²⁹However, it was then noted that such a mutual agreement process may lead to two wholly different outcomes: confirming the entitlement of a CIV to treaty benefits in its own right; or,

(Footnote continued in next column.)

With particular regard to the application of the beneficial ownership requirement to CIVs, paragraph 6.14 of the new commentary to article 1 reads as follows:

Accordingly, a vehicle that meets the definition of a widely-held CIV will also be treated as the beneficial owner of the dividends and interest that it receives, so long as the managers of the CIV have discretionary powers to manage the assets generating such income (unless an individual who is a resident of the State who would have received the income in the same circumstances would not have been considered to be the beneficial owner thereof).

It was further stated that the investor in a CIV differs from one that owns the underlying assets, with the result that it would not be appropriate to treat the investor in such a CIV as the beneficial owner of the income received by the vehicle.

However, it was recognized that these principles are necessarily general and that their application to any particular CIV may not be clear. Moreover, the commentary addressed the question whether existing treaty provisions are adequate to ensure CIVs are not used in a potentially abusive manner (that is, for treaty shopping).

It is doubtful that the 2010 update to the OECD model helped more generally in clarifying the beneficial owner test, given its relevance for CIVs only and its general principal nature, along with the apparent inconsistency with the existing commentary to articles 10, 11, and 12.³⁰

5. Proposed Changes: Commentary on Articles 10, 11, 12

a. 2011 OECD discussion draft on the meaning of beneficial owner. Given the risks of double taxation and non-taxation arising from the different interpretations provided by courts and tax administrations regarding the beneficial owner concept found in articles 10, 11, and 12 of the OECD model, the Committee on Fiscal Affairs, through Working Party 1 on Tax Conventions and Related Questions, has worked on proposals designed to clarify the interpretation that should be given to that concept in the context of the model. Therefore, on April 29, 2011, the OECD released a public discussion draft entitled “Clarification of the Meaning of ‘Beneficial Owner’ in the OECD Model Tax Convention” and invited all interested parties to submit their comments. The discussion draft is not designed to amend articles 10, 11, and 12 of the OECD model but instead proposes to revise the OECD commentary used to interpret those articles.

alternatively, dealing with the administrative issues of looking through the CIV to address the position of treaty-eligible underlying investors.

³⁰See Richard Collier, “Clarity, Opacity and Beneficial Ownership,” *Brit. Tax Rev.* No. 6 (2011).

Since identical changes have been proposed for articles 10 (dividends), 11 (interest), and 12 (royalties), the following analysis focused on article 10 is also intended to be applicable to the other two articles.

The most relevant changes to the existing text of the commentary are provided below, with additions in italics and deletions in strikethrough.

12. The requirement of beneficial owner was introduced in paragraph 1 of Article 10 to clarify the meaning of the words “paid . . . to a resident” as they are used in paragraph 1 of the Article. It makes plain that the State of source is not obliged to give up taxing rights over dividend income merely because that income was ~~immediately received by~~ *paid direct* to a resident of a State with which the State of source had concluded a convention. [The rest of the paragraph has been moved to new paragraph 12.1.]

12.1 Since the term “beneficial owner” was added to address potential difficulties arising from the use of the words “paid to . . . a resident” in paragraph 1, it was intended to be interpreted in this context and not to refer to any technical meaning that it could have had under the domestic law of a specific country (in fact, when it was added to the paragraph, the term did not have a precise meaning in the law of many countries). The term “beneficial owner” is therefore not used in a narrow technical sense (such as the meaning that it has under the trust law of many common law countries¹), rather, it should be understood in its context, in particular in relation to the words “paid . . . to a resident”, and in light of the object and purposes of the Convention, including avoiding double taxation and the prevention of fiscal evasion and avoidance. This does not mean, however, that the domestic law meaning of “beneficial owner” is automatically irrelevant for the interpretation of that term in the context of the Article: that domestic law meaning is applicable to the extent that it is consistent with the general guidance included in this Commentary.

[Footnote to paragraph 12.1]

¹*For example, where the trustees of a discretionary trust do not distribute dividends earned during a given period, these trustees, acting in their capacity as such (or the trust, if recognized as a separate taxpayer), could constitute the beneficial owners of such income for the purposes of Article 10, notwithstanding that the relevant trust law might distinguish between legal and beneficial ownership.*

According to the discussion draft, paragraph 12 of article 10 has been split into two parts, with the second one (paragraph 12.1) containing the major change of an additional explanation of the meaning of beneficial owner.

The first interpretative question about the beneficial ownership requirement has been whether the term should be defined by reference to the domestic tax law

of the source state or whether it should be given a contextual meaning under article 3(2) of the OECD model. The discussion draft makes it clear that the term “beneficial owner” as used in the OECD model is not intended to be interpreted based on, or to refer to, any technical meaning that it could have under the domestic law of a specific country; rather, the term should be understood in its treaty context, in particular regarding the phrase “paid . . . to a resident” in paragraph 1, and in light of the object and purposes of the model treaty, including avoiding double taxation and preventing fiscal evasion and avoidance.

That additional explanation clearly suggests the need for a treaty-based international approach, although the last sentence of paragraph 12.1 recognizes that domestic law may be applicable if consistent with the general guidance in the commentary, presumably in an attempt to achieve some sort of compromise. By stating that the term “beneficial owner” is therefore not used in a narrow technical sense, the OECD attempts to address one of the most controversial questions regarding the beneficial ownership requirement, namely its application to trusts. The discussion draft, relying on a definition of beneficial ownership that does not coincide with that adopted under common law, clarifies in a footnote that when the trustees of a discretionary trust do not distribute dividends earned during a given period, the trustees, acting in their capacity as such, can constitute the beneficial owners of that income for purposes of article 10, even though the relevant trust law might distinguish between legal and beneficial ownership.³¹

*12.12 Where an item of income is ~~received by~~ paid to 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~~ *direct* recipient of the income as a resident of the other Contracting State. The ~~immediate~~ *direct* 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. [The rest of the paragraph has been moved to new paragraph 12.3.]*

12.3 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

³¹By way of that example, the 2011 draft makes it clear that the term “beneficial owner,” as it is understood in the domestic law of common law countries, is not the appropriate test, since common law is based on the principle that ownership is indivisible and recognizes only legal ownership.

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”¹ concludes that a conduit company cannot normally be regarded as the beneficial owner if, through 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.

[Footnote to paragraph 12.3]

¹Reproduced at page R(6)-1 of Volume II of the full-length loose-leaf version of the OECD model convention.

12.4 In these various examples (agent, nominee, conduit company acting as a fiduciary or administrator), the recipient of the dividend is not the “beneficial owner,” because that recipient does not have the full right to use and enjoy the dividend that it receives, and this dividend is not its own; the powers of that recipient over that dividend are indeed constrained in that the recipient is obliged (because of a contractual, fiduciary or other duty) to pass the payment received to another person. The recipient of a dividend is the “beneficial owner” of that dividend where he has the full right to use and enjoy the dividend unconstrained by a contractual or legal obligation to pass the payment received to another person. Such an obligation will normally derive from relevant legal documents but may also be found to exist on the basis of facts and circumstances showing that, in substance, the recipient clearly does not have the full right to use and enjoy the dividend; also, the use and enjoyment of a dividend must be distinguished from the legal ownership, as well as the use and enjoyment, of the shares on which the dividend is paid.

New paragraph 12.4 would expand the discussion of the agent or nominee and conduit cases and would elaborate on a general and potentially wide interpretation of the meaning of beneficial owner based on a two-prong test: i) the person’s full right to use and enjoy the payment as its own; and ii) the absence of an obligation to pass on the payment received to somebody else. Also, new paragraph 12.4 would adopt a substance-over-form approach when stating that that obligation could be found to exist based on facts and circumstances, showing in substance, and beyond legal or contractual documents, that the recipient does not have the full right to use and enjoy the income.

While new paragraphs 12.2 and 12.3 preserve the examples set out in paragraph 12.1 of the 2010 commentary in providing an explanation of what is not

beneficial ownership,³² new paragraph 12.4 attempts to propose a general definition of the requirement by positively explaining what beneficial ownership is.³³

The discussion draft requires the beneficial owner to have the “full right to use and enjoy the dividend, unconstrained by a contractual or legal obligation to pass the payment received to another person.” It also states that although such an obligation is normally derived from the relevant legal documentation, it might also be found to exist based on facts and circumstances showing that in substance, the recipient clearly does not have the full right to use and enjoy the income. Finally, new paragraph 12.4 makes it clear that the use and enjoyment of a dividend is to be distinguished from both the legal ownership and the use and enjoyment of the shares upon which the dividend is paid.³⁴

12.5 The fact that the recipient of a dividend is considered to be the beneficial owner of that dividend does not mean, however, that the limitation of tax provided for by paragraph 2 must automatically be granted. This limitation of tax should not be granted in cases of abuse of this provision (see also paragraphs 17 and 22 below). As explained in the section on “Improper use of the Convention” in the Commentary on Article 1, there are many ways of addressing conduit companies and, more generally, treaty shopping situations. These include specific treaty anti-abuse provisions, general anti-abuse rules and substance-over-form or economic substance approaches. Whilst the concept of “beneficial owner” deals with some forms of tax avoidance (i.e. those involving the interposition of a recipient who is obliged to pass the dividend to someone else), it does not deal with other cases of treaty shopping and must not, therefore, be considered as restricting in any way the application of other approaches to addressing such cases.

³²On the one hand, new paragraph 12.2 states that when a payment is made to a resident acting as agent or nominee, that agent or nominee would not qualify as a beneficial owner. On the other hand, new paragraph 12.3 provides that a resident acting as a conduit for another party, otherwise than through an agency or nominee relationship, also cannot be regarded as the beneficial owner of the income concerned.

³³Before trying to explain the autonomous treaty definition of beneficial ownership, new paragraph 12.4 clarifies why agents, nominees, and conduit companies acting in a similar capacity are not beneficial owners. It states in particular that in these various examples, the recipient does not have the full right to use and enjoy the dividend that it receives, since the recipient’s powers are constrained because it is obliged to pass on the payment received to another person.

³⁴See Robert Danon (University of Neuchâtel), “Clarification of the Meaning of ‘Beneficial Owner’ in the OECD Model Tax Convention — Comment on the April 2011 Discussion Draft,” *Tax Treaty Monitor*, IBFD BIT 8/2011 (“the definition proposed by the discussion draft correctly makes it clear that the OECD Model only refers to the beneficial owner of an item of income. Accordingly, whether or not the recipient of the income is also the owner of the underlying asset is not decisive”).

12.6 The above explanations concerning the meaning of “beneficial owner” make it clear that the meaning given to this term in the context of the Article must be distinguished from the different meaning that has been given to that term in the context of other instruments¹ that concern the determination of the persons (typically the individuals) that exercise ultimate control over entities or assets. That different meaning of “beneficial owner” cannot be applied in the context of the Article. Indeed, that meaning, which refers to natural persons (i.e. individuals), cannot be reconciled with the express wording of subparagraph 2a), which refers to the situation where a company is the beneficial owner of a dividend. Since, in the context of Article 10, the term beneficial owner is intended to address difficulties arising from the use of the word “paid” in relation to dividends, it would be inappropriate to consider a meaning developed in order to refer to the individuals who exercise “ultimate effective control over a legal person or arrangement.”²

[Footnotes to paragraph 12.6]

¹ See, for example, the Glossary to the Financial Action Task Force’s Forty Recommendations (http://www.fatf-gafi.org/glossary/0,3414,en_32250379_32236930_35433764_1_1_1_1,00.html#34276864), which sets forth in detail the international anti-money laundering standard and which includes the following definition of beneficial owner: “the natural person(s) who ultimately owns or controls a customer and/or the person on whose behalf a transaction is being conducted. It also incorporates those persons who exercise ultimate effective control over a legal person or arrangement.” Similarly, the 2001 report of the OECD Steering Group on Corporate Governance, “Behind the Corporate Veil: Using Corporate Entities for Illicit Purposes,” <http://publications.oecd.org/acrobatebook/2101131E.PDF>, at page 14, defines beneficial owner as follows:

In this Report, “beneficial owner” refers to ultimate beneficial owner or interest by a natural person. In some situations, uncovering the beneficial owner may involve piercing through various intermediary entities and/or individuals until the true owner who is a natural person is found. With respect to corporations, ownership is held by shareholders or members. In partnerships, interests are held by general and limited partners. In trusts and foundations, beneficial owner refers to beneficiaries, which may also include the settlor or founder.

² Glossary to the Financial Action Task Force’s Forty Recommendations (http://www.fatf-gafi.org/glossary/0,3414,en_32250379_32236930_35433764_1_1_1_1,00.html#34276864).

Under new paragraph 12.5, being the beneficial owner of a dividend does not guarantee treaty relief or exemption when an abuse of that provision occurs. The discussion draft points out that while the concept of beneficial owner deals with some forms of tax avoidance — that is, those involving the interposition

of a recipient that is obliged to pass the dividend to someone else — it does not address other cases of treaty shopping, and therefore, must not be intended to override or prevent the application of other antiabuse provisions, whether specific or general.

The discussion draft also clarifies that the meaning of beneficial owner in the treaty must be distinguished from the meaning given to the term under different instruments concerning the determination of the persons that exercise ultimate control over entities or assets. In particular, the proposed paragraph 12.6 makes it clear that the meaning of beneficial owner under the international anti-money-laundering standard or other regulations on the illicit use of corporate entities cannot be applied to tax treaties.³⁵ In other words, the discussion draft points out that beneficial ownership and ultimate beneficial ownership are not to be equated, so an entity to which the income is paid may well be regarded as the beneficial owner, even if other persons (typically shareholders) exercise ultimate effective control over the entity.

12.72 Subject to other conditions imposed by the Article, the limitation of tax in the State of source remains available when an intermediary, such as an agent or nominee located in a Contracting State or in a third State, is interposed between the beneficiary and the payer, but the beneficial owner is a resident of the other Contracting State (the text of the Model was amended in 1995 to clarify this point, which has been the consistent position of all Member countries). States which wish to make this more explicit are free to do so during bilateral negotiations.

b. 2012 OECD revised discussion draft on the meaning of beneficial owner. In light of the comments received on the first discussion draft, OECD Working Party 1 made a number of changes to the proposals released in April 2011. Therefore, on October 19, 2012, the OECD released a revised discussion draft designed to further clarify the beneficial owner test. The OECD has requested comments on the proposed additions and changes to the commentary on articles 10, 11, and 12, specifying that comments should focus on drafting issues rather than matters of substance. The proposals set out in the revised discussion draft are therefore expected to be incorporated into the next update to the commentary in June 2014.

³⁵ See “Beneficial Ownership and Double Tax Agreements,” presented by Craig Elliffe (University of Auckland), at the 2012 tax conference held in Wellington, New Zealand, on October 26-27, 2012. Elliffe further clarifies that the focus in tax treaties is different, with the concept of beneficial ownership looking at who was effectively the owner of a dividend, while tests for money laundering or other illicit uses of corporate entities have as their primary focus the determination of those persons that exercise ultimate control over entities or assets.

The most relevant revised proposals are indicated below by underlined changes to the first discussion draft:

12.1 Since the term “beneficial owner” was added to address potential difficulties arising from the use of the words “paid to . . . a resident” in paragraph 1, it was intended to be interpreted in this context and not to refer to any technical meaning that it could have had under the domestic law of a specific country (in fact, when it was added to the paragraph, the term did not have a precise meaning in the law of many countries). The term “beneficial owner” is therefore not used in a narrow technical sense (such as the meaning that it has under the trust law of many common law countries¹), rather, it should be understood in its context, in particular in relation to the words “paid . . . to a resident”, and in light of the object and purposes of the Convention, including avoiding double taxation and the prevention of fiscal evasion and avoidance. This does not mean, however, that the domestic law meaning of “beneficial owner” is automatically irrelevant for the interpretation of that term in the context of the Article: that domestic law meaning is applicable to the extent that it is consistent with the general guidance included in this Commentary.

[Footnote to paragraph 12.1]

¹For example, where the trustees of a discretionary trust do not distribute dividends earned during a given period, these trustees, acting in their capacity as such (or the trust, if recognised as a separate taxpayer), could constitute the beneficial owners of such income for the purposes of Article 10 even if they are not the beneficial owners under the relevant trust law notwithstanding that the relevant trust law might distinguish between legal and beneficial ownership.

The last sentence of paragraph 12.1 — stating that having an autonomous treaty meaning does not mean that the domestic law interpretation of beneficial owner is irrelevant when interpreting that term — has now been removed, the revised discussion draft having acknowledged that this apparent contradiction created confusion and, in some cases, the perception that the commentary could be read as allowing a taxpayer to choose between the domestic law interpretation and the OECD interpretations.³⁶

³⁶The working party agreed to delete that last sentence on the basis that further guidance is potentially confusing and may be unnecessary, because taxpayers (unless the context specifies otherwise) are required under article 3(2) to take the meaning of any undefined term (such as “beneficial ownership”) as being applicable under the domestic tax laws of the contracting state. Article 3(2) reads as follows:

As regards the 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

(Footnote continued in next column.)

Regarding the footnote to paragraph 12.1 and, more generally, the application of the “beneficial owner” concept for trusts, the comments generally supported the interpretation put forward therein, although some of them expressed the view that it was difficult to reconcile the conclusion of the footnote with the concept of the “full right to use and enjoy the income” in proposed paragraph 12.4, since a trustee does not have full rights regarding the trust income. Given the above, the working party decided to leave the footnote unchanged except for a clarifying change made to the last part of that footnote. Regarding the difficulty of reconciling the footnote with the concept of full right to use and enjoy the income in paragraph 12.4, it also concluded that the issue should be dealt with through amendments to paragraph 12.4.

12.4 In these various examples (agent, nominee, conduit company acting as a fiduciary or administrator), the recipient of the dividend is not the “beneficial owner” because that recipient’s right to use and enjoy the dividend is constrained that recipient does not have the full right to use and enjoy the dividend that it receives and this dividend is not its own; the powers of that recipient over that dividend are indeed constrained in that the recipient is obliged (because of a contractual, fiduciary or other duty) to pass the payment received to another person. The recipient of a dividend is the “beneficial owner” of that dividend where he has the full right to use and enjoy the dividend unconstrained by a contractual or legal obligation to pass on the payment received to another person. Such an obligation will normally derive from relevant legal documents but may also be found to exist on the basis of facts and circumstances showing that, in substance, the recipient clearly does not have the full right to use and enjoy the dividend unconstrained by a contractual or legal obligation to pass on the payment received to another person. This type of obligation must be related to the payment received; it would therefore not include contractual or legal obligations unrelated to the payment received even if those obligations could effectively result in the recipient using the payment received to satisfy those obligations. Examples of such unrelated

purposes of the taxes to which the convention applies, any meaning of the applicable tax laws of the State prevailing over meaning given to a term under other laws of that state.

It has been observed that the use of the word “requires” in the phrase “the context otherwise requires” arguably “requires that Article 3(2) is different from the rules in the VCLT (the Vienna convention) in that, a priori, it establishes a preferred domestic interpretation.” Michael N. Kadev, “Tax Treaty Interpretation: Determining Domestic Meaning Under Article 3(2) of the OECD Model,” *Can. Tax J.*, Vol. 55, No. 1, at 31, 68 (2007). If article 3(2) indicates that the contracting state should use the meaning that is found in the domestic law of the state, the revised discussion draft clarifies that this domestic law meaning will be constrained and modified by the autonomous treaty meaning — that is to say, the meaning of the term “beneficial owner” is ultimately to be found in the commentary.

obligations are those unrelated obligations that the recipient may have as a debtor or as a party to financial transactions or typical distribution obligations of pension schemes and of collective investment vehicles entitled to treaty benefits under the principles of paragraphs 6.8 to 6.34 of the Commentary on Article 1. Where the recipient of a dividend does have the right to use and enjoy the dividend unconstrained by a contractual or legal obligation to pass on the payment received to another person, the recipient is the “beneficial owner” of that dividend. It should also be noted that Article 10 refers to the beneficial owner of a dividend as opposed to the owner of the shares, which may be different in some cases. Also, the use and enjoyment of a dividend must be distinguished from the legal ownership, as well as the use and enjoyment, of the shares on which the dividend is paid.

Most of the comments received on the discussion draft were addressed at the phrase “full right to use and enjoy the dividend” in the first sentence of paragraph 12.4, which was criticized as being far-reaching and adding further confusion and subjectivity to the interpretation of the concept of beneficial ownership. Some commentators suggested that the phrase could apply to a number of legitimate situations³⁷ and expressed specific concerns about the uncertainty regarding the effect of the proposed commentary on a number of typical financial transactions and on the use of holding companies, as well as CIVs.

In light of the above comments, the working party recognized that the drafting of paragraph 12.4 could give rise to significant uncertainty and that it needed to better identify the kinds of obligations that would mean that the recipient of a payment would not be considered the beneficial owner of that payment.

³⁷According to the comments submitted to the OECD, those situations may include:

- the use of the income received to meet other costs, such as interest that the recipient has to pay to a creditor;
- the activities of banks or, more generally, any type of financial institution;
- the use of holding companies;
- entities, such as unit trusts, that are required to distribute their income;
- payments of interest or dividends under “plain vanilla” securities or hybrid arrangements such as convertible debentures;
- a creditor who obtains a court order that freezes the income of the debtor;
- an individual who is obliged to make alimony payments to his former spouse;
- the payment of a dividend by a subsidiary to its parent;
- trusts;
- the use of a special purpose vehicle in securitization arrangements or to ring-fence commercial risks;
- a debtor pledges shares or loan notes and the resulting income to its bank as security for a loan;
- joint venture arrangements that require distributions;
- hedging in the financial services industry; and
- various financial products (for example, repos and credit derivatives, including credit default swaps).

The phrase “full right to use and enjoy” income was therefore reduced to the “right to use and enjoy” — the term “full” was considered to introduce needless complexity — while the OECD’s statement on the beneficial owner test being failed when the recipient is “constrained by a contractual or legal obligation to pass [on] the payment received to another person” was retained. In this regard, the revised discussion draft clarified that such an obligation must be for the payment received, and would therefore not include contractual or legal obligations unrelated to that payment, even if those obligations could result in the recipient using the payment received to satisfy them.³⁸ It also provided examples of these unrelated obligations, which would include those that the recipient may have as a debtor or party to financial transactions, or typical distribution obligations of pension schemes and CIVs.

Since a number of commentators remarked that the words “unconstrained by a contractual or legal obligation” used in the second sentence were different from the words “constrained in that the recipient is obliged (because of a contractual, fiduciary or other duty)” in the preceding sentence, the working party redrafted the paragraph, trying to use the same terminology as much as possible.

The comments on the first part of the last sentence of the paragraph were disregarded in the 2012 draft, which retained the OECD’s statement that an obligation can be found to exist based on “facts and circumstances” that show, in substance, that the recipient does not have the right to use and enjoy the income.³⁹

Finally, the distinction made in the last part of paragraph 12.4 — between the use and enjoyment of a dividend and the legal ownership, as well as the use and enjoyment of the shares on which the dividend is paid — was considered appropriate and therefore retained by the working party, with a few minor changes to the previous wording.

³⁸It has been observed that:

It is certainly helpful that there are the additional comments now inserted on the fact that unrelated payments do not affect the beneficial owners position of income received . . . but this simply leads to the obvious question: what does it mean for a payment to be related or unrelated? It is clear that this is the key concept. . . . There is, however, no word of explanation on the meaning of this term. . . . Whether payments are related might be determined by a large number of possible criteria. . . . The point, in short, is that use of the terms related/unrelated without any explanation relocates the discussion on the beneficial owner test but does not solve it.

PricewaterhouseCoopers LLP, “OECD Releases Revised Discussion Draft on Beneficial Ownership,” *Tax Pol. Bull.*, Oct. 22, 2012.

³⁹Some commentators suggested that that part of the last sentence contradicted the guidance in the preceding part of the paragraph and argued that it would have the effect of introducing an economic ownership test.

12.5 The fact that the recipient of a dividend is considered to be the beneficial owner of that dividend does not mean, however, that the limitation of tax provided for by paragraph 2 must automatically be granted. This limitation of tax should not be granted in cases of abuse of this provision (see also paragraphs 17 and 22 below). As explained in the section on “Improper use of the Convention” in the Commentary on Article 1, there are many ways of addressing conduit company and, more generally, treaty shopping situations. These include specific ~~treaty~~ anti-abuse provisions in treaties, general anti-abuse rules and substance-over-form or economic substance approaches. Whilst the concept of “beneficial owner” deals with some forms of tax avoidance (i.e. those involving the interposition of a recipient who is obliged to pass on the dividend to someone else), it does not deal with other cases of treaty shopping and must not, therefore, be considered as restricting in any way the application of other approaches to addressing such cases.

Some commentators suggested regarding paragraph 12.5 that the concept of beneficial owner should not be referred to as an antiavoidance rule and seemed to object to the conclusion that a beneficial owner might not be entitled to treaty benefits under other antiabuse rules. In particular, a number of comments pointed out that the inclusion of a discussion on antiavoidance mechanisms within the sections of the commentary discussing beneficial ownership might be misinterpreted by tax authorities as a requirement to apply additional antiavoidance testing as part of the determination of beneficial ownership.

The working party, however, strongly disagreed with the view that a beneficial owner should be immune from the application of other antiabuse rules because of its inconsistency with the guidance already included in paragraphs 7 to 26.1 of the commentary on article 1.

The revised discussion draft therefore did not modify paragraph 12.5, apart from two minor clarifying changes.

12.6 The above explanations concerning the meaning of “beneficial owner” make it clear that the meaning given to this term in the context of the Article must be distinguished from the different meaning that has been given to that term in the context of other instruments¹ that concern the determination of the persons (typically the individuals) that exercise ultimate control over entities or assets. That different meaning of “beneficial owner” cannot be applied in the context of the Article. Indeed, that meaning, which refers to natural persons (i.e. individuals), cannot be reconciled with the express wording of subparagraph 2 a), which refers to the situation where a company is the beneficial owner of a dividend. Since, in the context of Article 10, the term “beneficial owner” is intended to address difficulties arising from the use of the words “paid to” in relation to dividends, rather than difficulties related to the ownership of the shares of the company paying these dividends. For that reason, it would be inappropriate, in the context of that Article, to

*consider a meaning developed in order to refer to the individuals who exercise “ultimate effective control over a legal person or arrangement.”*²

[Footnotes to paragraph 12.6]

¹See, for example, *Financial Action Task Force, International Standards on Combating Money Laundering and the Financing of Terrorism & Proliferation — The FATF Recommendations (OECD-FATF, Paris, 2012)*, the Glossary to the Financial Action Task Force’s Forty Recommendations (http://www.fatf-gafi.org/glossary/0,3414,en_32250379_32236930_35433764_1_1_1_1,00.html#34276864) which sets forth in detail the international anti-money laundering standard and which includes the following definition of beneficial owner (at page 109): “the natural person(s) who ultimately owns or controls a customer and/or the person on whose behalf a transaction is being conducted. It also incorporates those persons who exercise ultimate effective control over a legal person or arrangement.” Similarly, the 2001 report of the OECD Steering Group on Corporate Governance, “Behind the Corporate Veil: Using Corporate Entities for Illicit Purposes” (OECD, Paris, 2001), <http://publications.oecd.org/acrobatebook/2101131E.PDF>, at page 14, defines beneficial ownership as follows (at page 14):

In this Report, “beneficial ownership” refers to ultimate beneficial ownership or interest by a natural person. In some situations, uncovering the beneficial owner may involve piercing through various intermediary entities and/or individuals until the true owner who is a natural person is found. With respect to corporations, ownership is held by shareholders or members. In partnerships, interests are held by general and limited partners. In trusts and foundations, beneficial ownership refers to beneficiaries, which may also include the settlor or founder.

²See the Financial Action Task Force’s definition quoted in the previous note. Glossary to the Financial Action Task Force’s Forty Recommendations (http://www.fatf-gafi.org/glossary/0,3414,en_32250379_32236930_35433764_1_1_1_1,00.html#34276864).

Given the difficulty in finding a single, universal meaning of the term “beneficial owner,” regardless of the context in which it is used (as suggested by a number of commentators), the 2012 draft maintained the distinction reflected in paragraph 12.6. The working party, however, redrafted the last sentence in order to clarify its meaning and modified the footnotes to refer to the published versions of the reports mentioned therein.

Changes were made to the preamble of paragraph 2 of article 10:

2. However, such dividends paid by a company which is a resident of a Contracting State may also be taxed in that State the Contracting State of which the company paying the dividends is a resident

and according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed: . . .

A change was made to paragraph 12.2 (now 12.7) of the commentary on article 10:

12.7~~2~~ Subject to other conditions imposed by the Article, the limitation of tax in the State of source remains available when an intermediary, such as an agent or nominee located in a Contracting State or in a third State, is interposed between the beneficiary and the payer but the beneficial owner is a resident of the other Contracting State (the text of the Model was amended in 1995 *and in [year of next update]* to clarify this point, which has been the consistent position of all Member countries). States which wish to make this more explicit are free to do so during bilateral negotiations.

The OECD agreed to address in the revised discussion draft the issue of how treaty article 10 applies when the direct recipient and beneficial owner are in two different states. A literal interpretation of the words “such dividends” in the preamble of paragraph 2 of article 10 could lead to the conclusion that these dividends must be paid directly to a resident of a contracting state, which would be problematic when the direct recipient and the beneficial owner of the dividends are residents of two different states. While existing paragraph 12.2 of the commentary clearly indicates that such an interpretation should be rejected, it suggests that some states may wish to adopt clearer wording in their income tax treaties. The working party decided that in order to remove any doubt, that clearer wording should be included in the article itself. At the same time, it decided to clarify in the commentary that this issue was dealt with through two different changes to the wording of the article, since the 1995 change that is already referred to in paragraph 12.2 only addressed the issue when the direct recipient and beneficial owner of the dividends are both residents of the same state.

C. Int’l Case Law and Administrative Guidance

1. *Aiken Industries*

In *Aiken Industries Inc. v. Commissioner*, 56 T.C. 925 (1971), back-to-back loans, in the identical amount of principal and interest, were made between a U.S. corporation and a related corporation organized under the laws of Honduras, and between the Honduran corporation and its indirect parent.

No withholding tax was due on the interest paid by the U.S. corporation to the Honduran corporation under the Honduras-U.S. tax treaty, and no withholding tax was charged on the interest paid by the Honduran corporation to its indirect parent under Honduran law.

Had the interest been paid directly by the U.S. corporation (the ultimate borrower) to the indirect parent

(the ultimate lender), a 30 percent withholding tax would have applied under U.S. law.

The Tax Court emphasized the identity in both terms and payments between the back-to-back loans, as well as the close relationships between the parties involved, and saw the transaction as an attempt to channel outbound interest payments through a corporation based in a treaty partner to avoid the U.S. withholding tax.

It ruled against the taxpayer and held that the withholding tax was due, as if the interest had flowed directly from the ultimate borrower (U.S.) to the ultimate lender (the non-treaty-partner resident).

The taxpayer lost because the treaty partner corporation earned no profit from the transaction, and was passing debt service payments on to the ultimate lender simultaneously with receipt of those payments from the ultimate borrower. Although the Honduras-U.S. treaty exempted interest received by a treaty partner resident (and the Honduran corporation was respected and not treated as a sham), the court interpreted the phrase “received by” to require dominion and control over the funds, and concluded that the intermediary had no such control and, instead, functioned as a collection agent.

2. *Northern Indiana Public Service*

In *Northern Indiana Public Service Co. v. Commissioner*, 105 T.C. 341, 350 (1995), *on appeal* (7th Cir. March 13 and 25, 1996), a U.S. corporation organized a finance subsidiary in Curaçao, then part of the Netherlands Antilles (to which the Netherlands-U.S. treaty applied) to issue notes in the Eurobond market. The finance subsidiary borrowed \$70 million at a 17.25 percent interest rate in the market and lent that amount to its U.S. parent at an 18.25 percent interest rate.

Like in *Aiken Industries*, no withholding tax applied on the interest payments (under the Netherlands-U.S. treaty and Netherlands Antilles domestic law).

The Tax Court found that the Dutch finance subsidiary (unlike the Honduran subsidiary in *Aiken Industries*) engaged in substantive business activity that resulted in significant earnings, and held that the finance subsidiary was not a mere conduit or agent and was relieved of withholding tax under the treaty.

The lesson from *Aiken Industries* and *Northern Indiana* was that the financial intermediary, at a minimum, must earn a profit — that is, charge more interest from the ultimate borrower than it pays to the ultimate lender — to be entitled to treaty benefits.

The international finance subsidiary industry that existed in the Netherlands Antilles before the enactment of the portfolio interest exemption in 1984 is ample testimony of that principle.

The decision of the U.K. Court of Appeal in *Indofood* has changed this assumption (at least at the international level) and caused new debate on the issue.

3. *Indofood*

Indofood, an Indonesian multinational company, wished to raise funds through the issue of internationally marketed loan notes. It did so through a finance subsidiary organized in Mauritius.

Under the Indonesia-Mauritius treaty, the withholding tax charged on the interest paid by the Indonesian company to the Mauritian subsidiary was reduced to a rate of 10 percent (from the 20 percent Indonesian statutory withholding tax rate). Mauritius did not charge any withholding tax on interest paid by the Mauritian finance subsidiary to the note holders.

Under the terms of the loan note issue, if the withholding tax on the notes increased to above 10 percent and no reasonable measure could be found to avoid it, the Indonesian company, which would pay for the increase, would be entitled to redeem the notes. JPMorgan Chase & Co. represented the note holders as trustee, and the loan note issue referred any disputes to the U.K. courts.

Indonesia decided to terminate the treaty with Mauritius.

The withholding tax consequently increased to the full 20 percent Indonesian statutory rate, and the Indonesian company asked to redeem the notes.

JPMorgan rejected the request and suggested, as a reasonable measure to avoid the higher withholding tax, that the Indonesian company set up a finance intermediary in the Netherlands to perform the same functions as the Mauritian subsidiary. The loan between that subsidiary and the Indonesian parent would be transferred to the new Dutch finance subsidiary, and no withholding tax would be charged under the Indonesia-Netherlands tax treaty.

The Indonesian company rejected that solution, and the dispute was referred to the U.K. courts.

One of the questions that the U.K. Court of Appeal had to decide was whether the Dutch subsidiary would be treated as the beneficial owner of the interest payments received from the note holders and be eligible for the exemption from withholding tax under the Indonesia-Netherlands tax treaty.

The court found that the Dutch subsidiary — although it earned a spread on the loan to its parent and satisfied the substance and risk requirements for finance companies provided for under Dutch tax law — had only limited powers over the interest income. It did not derive any direct benefit from the interest received from note holders (other than to fund its liability under the loan with the parent) and was even obliged to use it to pay the interest due to the parent. The two loan agreements also had very tight payment deadlines.

The court referred to the international fiscal meaning of the term “beneficial ownership” as it appears in the commentary to the OECD model, which requires power of disposing of income to be received for the recipient’s direct benefit, as opposed to what it called a

narrow technical domestic law meaning of the term. It held that under that international tax standard, the Dutch subsidiary did not qualify as the beneficial owner of the income and would be subject to full withholding tax.

4. *International Reactions to Indofood*

a. ABA debate. Speaking on March 17, 2006, at the American Bar Association Section of Taxation conference in Washington (prior coverage: *Tax Notes Int’l*, Mar. 27, 2006, p. 1047), Diane Hay, then-deputy director, business international, HM Revenue & Customs, said:

It represents a very strong ruling against treaty shopping. In a way, it is a very awkward situation for us, since now we have to look at what was previously ok . . . and see if we can say structured finance is still going to be ok using these arrangements.

Patricia Brown, then-U.S. Treasury deputy international tax counsel, said that beneficial ownership “is being used now against taxpayers in a variety of circumstances to deny treaty benefits in cases where I do not think it is really appropriate, and certainly not anticipated by people who put it into the model.” She found the *Indofood* decision troublesome. She said the court’s statement that the definition of beneficial ownership is a matter of international law and not a matter of domestic law of the source country is disturbing.

Brian Ernewein, director of tax legislation for Canada’s Department of Finance, remarked that:

It does help us when we are trying to constrain a given country when that country is trying to constrain treaty benefits on what it thinks may be an abusive situation . . . but it does not help us if another country is applying it in a situation we do not think is appropriate to constrain the application of a treaty.

b. 2006 Indonesian ruling on beneficial ownership. The Indonesian tax authority’s Ruling Letter S-95/PJ.342/2006 states that the factors to be considered in conforming to beneficial ownership of income for treaty purposes include:

- whether all the income received from the source country is subject to tax in the country of residence or domicile that would be eligible for the treaty benefits;
- whether the foreign company has an active business operation;
- whether the foreign company has a full right to all the interest it received from the source country to finance its business operations; and
- whether the foreign company’s shares are listed on a recognized stock exchange.

There is evidence that tax authorities in other countries may review existing financing structures under the beneficial ownership requirement.⁴⁰

5. *Prévost Car Inc. and Velcro Canada Inc.*

Recent Canadian jurisprudence on the meaning of beneficial owner provided guidance on the way in which Canadian courts have interpreted this concept in a tax treaty context. In particular, *Prévost Car Inc.*⁴¹ and *Velcro Canada Inc.*,⁴² both in favor of taxpayers, have taken a clear legal-form-based approach by dismissing the reasoning of the U.K. court in the landmark *Indo-food* case.

a. Prévost Car Inc. *Prévost Car Inc.* is significant in that it is the first Canadian tax decision to consider the term “beneficial owner” in a treaty context. The taxpayer was a Canadian resident corporation engaged in manufacturing buses and related products. Volvo, a resident of Sweden, and Henlys, a resident of the United Kingdom, carried on business in the same industry as the taxpayer. In the early 1990s, Volvo and Henlys, as part of their strategy to expand into the North American market, decided to acquire the taxpayer through a holding company (Dutchco) incorporated in the Netherlands, partly for tax reasons, but also to have a European company resident in a neutral jurisdiction where business could be conducted in English.

On May 3, 1995, Volvo and Henlys entered into a shareholders’ subscription agreement by which Volvo undertook to transfer to Dutchco all of the shares acquired in the taxpayer and then sell 49 percent of the shares of Dutchco to Henlys. The shareholders’ agreement provided that no less than 80 percent of the profits of Dutchco and the taxpayer were to be distributed to the shareholders, subject to working capital requirements. The distribution for a fiscal year was to be declared and paid to the shareholders as soon as practicable, up to the end of the fiscal year. Further, the shareholders’ agreement contemplated that the board of directors of Dutchco should take reasonable steps to ensure that dividends were declared by the taxpayer or that other steps should be taken to ensure that Dutchco had funds available to pay dividends. Dutchco and the taxpayer were not parties to the shareholders’ agreement.

In early 1996, the taxpayer adopted a policy to pay quarterly dividends equal to 80 percent of its net after-tax profits, subject to working capital requirements. Dutchco’s documents provided that its board was authorized to reserve part of its accrued profits, with due

observance of the shareholders’ agreement, and also to pay interim dividends. Any interim dividends would become final only when the shareholders of Dutchco declared an annual dividend in a year-end resolution. During the years concerned, Dutchco had no employees in the Netherlands and no assets other than its investment in the shares of the taxpayer. Moreover, Dutchco paid its expenses with amounts advanced to it by Volvo and Henlys. The taxpayer paid dividends to Dutchco between 1996 and 2001, and Dutchco used those funds to pay dividends to Volvo and Henlys.

Under article 10(2) of the Canada-Netherlands tax treaty,⁴³ the rate of tax on dividends paid by a resident of Canada to a resident of the Netherlands was reduced to 5 percent, if “the beneficial owner is a company (other than a partnership) that holds directly or indirectly at least 25 percent of the capital or at least 10 percent of the voting power of the company paying the dividends.” This provision in the treaty was revised, effective January 15, 1999, to provide that the rate of tax would be reduced to 5 percent of the gross amount of the dividends “if the beneficial owner is a company (other than a partnership) and owns at least 25 percent of the capital of, or that controls directly or indirectly, at least 10 percent of the voting power in the company paying the dividends.”

The minister of national revenue (MNR) argued that Dutchco was not the beneficial owner of the dividends, as required by article 10(2) of the Canada-Netherlands treaty, but rather a mere conduit or funnel in favor of Volvo and Henlys on receiving dividends from the taxpayer, within the meaning of the conduit report.⁴⁴ Therefore, given that the rate of tax could not be reduced under the treaty, the MNR assessed the taxpayer for failure to withhold a sufficient amount of tax (the applicable rate of withholding was 15 percent for Volvo and 10 percent for Henlys).

⁴³The Convention Between Canada and the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income, signed in The Hague on May 27, 1986, as amended by the protocols signed March 4, 1993, and August 25, 1997.

⁴⁴“Double Taxation Conventions and the Use of Conduit Companies,” adopted by the OECD on November 27, 1986. In this regard, it has been observed that during the years at issue, the 1977 OECD commentary was the relevant authority for determining what the intended meaning of the term “beneficial owner” was. That commentary provided only that an entity acting as a nominee or agent would not be considered a beneficial owner. Since the conduit concept was introduced by the 2003 commentary, it has been suggested that:

It would have been preferable had Justice Rip avoided the “conduit” terminology. The simple answer should have been that there was no evidence that [Dutchco] was a nominee or agent and hence [Dutchco] was the beneficial owner of the dividends.

See Summerhill, Bernstein, and Barb Worndl, “Taxpayer Prevails in Canadian Beneficial Ownership Case,” *Tax Notes Int’l*, May 5, 2008, p. 363.

⁴⁰See Jack Bernstein and Louise R. Summerhill, “Canada Takes Aim at Concept of Beneficial Ownership,” *Tax Notes Int’l*, Aug. 28, 2006, p. 737.

⁴¹*Prévost Car Inc. v. The Queen*, 2008 TCC 231 (Apr. 22, 2008).

⁴²*Velcro Canada Inc. v. The Queen*, 2012 TCC 57 (Feb. 24, 2012).

In reaching its decision, and even with the argument of the Crown, the Tax Court of Canada, by reference to article 3(2) of the Canada-Netherlands treaty,⁴⁵ adopted a domestic solution in determining the meaning of beneficial owner, as follows:

In my view, the “beneficial owner” of dividends is the person who receives the dividends for his or her own use and enjoyment and assumes the risk and control of the dividend he or she received. The person who is beneficial owner of the dividend is the person who enjoys and assumes all the attributes of ownership. In short, the dividend is for the owner’s own benefit and this person is not accountable to anyone for how he or she deals with the dividend income. When the Supreme Court in *Jodrey* stated that the “beneficial owner” is one who can “ultimately” exercise the rights of ownership in the property, I am confident that the Court did not mean, in using the word “ultimately,” to strip away the corporate veil so that the shareholders of a corporation are the beneficial owners of its assets, including income earned by the corporation. The word “ultimately” refers to the recipient of the dividend who is the true owner of the dividend, a person who could do with the dividend what he or she desires. It is the true owner of property who is the beneficial owner of the property. Where an agency or mandate exists or the property is in the name of a nominee, one looks to find on whose behalf the agent or mandatary is acting or for whom the nominee has lent his or her name. When corporate entities are concerned, one does not pierce the corporate veil unless the corporation is a conduit for another person and has absolutely no discretion as to the use or application of funds put through it as conduit, or has agreed to act on someone else’s behalf pursuant to that person’s instructions, without any right to do other than what that person instructs it.⁴⁶

The court stated that this was not the relationship between Dutchco and its shareholders. It found that Dutchco was not a conduit for Volvo and Henlys, since there was no evidence that the dividends paid by the

taxpayer were *ab initio* destined for Volvo and Henlys. That finding was made despite Dutchco having no physical office or employees in the Netherlands or elsewhere. The Court pointed out that Volvo and Henlys would be entitled to dividends only when the directors of Dutchco had declared interim dividends and the shareholders had approved the dividends, so that there was no predetermined or automatic flow of funds to the two companies. That the shareholders’ agreement mandated the payment of dividends was not considered relevant since Dutchco was not a party to that agreement. Therefore, had the dividends not been paid, Henlys may have had a cause of action against Volvo, and Volvo a cause of action against Henlys, but neither would have had a bona fide action under the shareholders’ agreement against Dutchco. Moreover, Dutchco’s deed of incorporation did not obligate it to pay any dividends to its shareholders.⁴⁷ The court also found that funds received by Dutchco were assets of Dutchco, and available to its creditors unless and until dividends were paid. Accordingly, the court concluded that Dutchco was the beneficial owner of the dividends paid by the taxpayer and consequently was entitled to the benefit of the reduced rate of tax under the Canada-Netherlands treaty.

The *Prévost* decision rejected the broad definition of beneficial owner used in *Indofood* and, accordingly, the Canada Revenue Agency’s attempt to turn the beneficial owner requirement into an antiavoidance tool, beyond its original limited purpose, to limit treaty benefits when the recipient of the payment is an agent or a nominee. The court interpreted the term “beneficial owner” in a manner consistent with the common law concept of beneficial ownership, as the person that has the right to the benefits of the property. The decision makes it clear that a holding corporation is regarded as the beneficial owner of its property and, as such, is entitled to the benefits provided by a treaty, since one does not look through a corporation to its shareholders as the beneficial owners of corporate property unless the corporation has no discretion to deal with the property on its own or is acting as a mere trustee. Moreover, the court confirmed that in interpreting Canada’s tax treaties, the domestic definition of beneficial owner is appropriate, presumably challenging the possibility of an international fiscal meaning, as suggested in the *Indofood* case.

⁴⁵ Article 3(2) of the treaty provides that any term not defined in the treaty, unless the context otherwise requires, will have the meaning that it has under the law of that state concerning the taxes to which the treaty applies. Accordingly, when Canada wishes to impose tax, a term not defined in the treaty will have the meaning it has under the Income Tax Act (Canada), assuming it is defined in that act. Section 3 of the Income Tax Conventions Interpretation Act provides that when a term in a treaty is not defined or not fully defined therein, or is to be defined by reference to the laws of Canada, that term, except to the extent the context otherwise requires, has the meaning it has under the ITA.

⁴⁶ *Prévost Car Inc. v. The Queen*, 2008 TCC 231 (Apr. 22, 2008), para. 100.

⁴⁷ See also *Prévost Car Inc. v. The Queen*, 2008 TCC 231 (Apr. 22, 2008), para. 93, which reads as follows:

The decision in *Indofood* conflicts somewhat with the opinion of the Dutch government and the Hoge Raad in the Royal Dutch case . . . that a recipient is not the beneficial owner of income only if it is contractually obligated to pay the largest part of the income to a third party. In *Indofood*, the Court of Appeal did not base its reasoning on contractual obligation to forward the interest, but rather whether the recipient enjoyed the “full privilege” of the interest or if it was simply an “administrator of income.”

In a brief judgment, Canada's Federal Court of Appeal upheld the Tax Court decision and stated:

The Judge's formulation captures the essence of the concepts of "beneficial owner," "bénéficiaire effectif," as it emerges from the review of the general, technical and legal meanings of the terms. Most importantly, perhaps, the formulation accords with what is stated in the OECD Commentaries and in the Conduit Companies Report.

Counsel for the Crown has invited the Court to determine that "beneficial owner," "bénéficiaire effectif," "means the person who can, in fact, ultimately benefit from the dividend." That proposed definition does not appear anywhere in the OECD documents and the very use of the word "can" opens up a myriad of possibilities which would jeopardize the relative degree of certainty and stability that a tax treaty seeks to achieve. The Crown, it seems to me, is asking the Court to adopt a pejorative view of holding companies, which neither Canadian domestic law, the international community nor the Canadian government, through the process of objection, have adopted.⁴⁸

b. Velcro Canada Inc. Velcro Canada Inc. is the second Canadian tax case that considers the beneficial ownership requirement in a treaty context. This decision, which is in the taxpayer's favor, is significant in that it applied the guidance regarding beneficial ownership provided by the Tax Court in *Prévost* and affirmed on appeal.

In 1987 Velcro Canada Inc. (VCI) entered into a licensing agreement with Velcro Industries BV (VIBV) for the use of Velcro brand fastener technology in Canada (the first license agreement). From 1987 to October 1995, VCI paid royalties to VIBV. During that period, VIBV was a resident of the Netherlands and VCI withheld Canadian taxes from royalty payments at applicable rates in accordance with the Canada-Netherlands tax treaty. Following the reorganization of the Velcro group in 1995, VIBV became a resident of the Netherlands Antilles. On October 27, 1995, VIBV entered into an assignment agreement with Velcro Holdings BV (VHBV), a resident of the Netherlands, and assigned its rights and obligations in connection with the first license agreement to VHBV (the first assignment agreement). As a consequence, VCI was required, starting October 27, 1995, to pay royalties to VHBV under the first license agreement but subject to the first assignment agreement. VCI continued to withhold Canadian taxes from royalty payments to VHBV at applicable rates in accordance with the Canada-Netherlands tax treaty until 1998, when the withholding tax rate was reduced from 10 percent to 0 percent

under the treaty. Canada and the Netherlands Antilles do not have a tax treaty such that if the royalty payments had been made to VIBV instead of VHBV, the Canadian withholding tax rate on those payments would have been 25 percent. VIBV and VCI entered into a new license agreement on October 1, 2003, that superseded the first license agreement (the second license agreement). On the same day, the second license agreement was assigned by VIBV to VHBV (the second assignment agreement). There was no change in the flow of royalty payments by VCI to VHBV for the use of VIBV's intellectual property under the second assignment agreement. The terms and conditions of the second license and second assignment agreements were similar to those of the first license and first assignment agreements. Those license agreements allowed VCI to use VIBV's intellectual property in the manufacturing and selling of fastening products in exchange for royalty payments, while VIBV maintained ownership of the intellectual property. VCI was granted the right to manufacture, sell, and distribute the licensed products, and to use the related licensed trademark. Under the assignment agreements, VHBV was given the right to grant licenses to VCI for VIBV's intellectual property in exchange for royalty payments to VIBV, and by operation of the agreements, VHBV became the licensor of this intellectual property to VCI. The amount of royalty payments made by VHBV to VIBV under the assignment agreements was equal to 90 percent of the royalties received from VCI under any licensing agreement and was payable within 30 days of receiving royalty payments from VCI.

The principal question before the Tax Court was whether the beneficial owner of the royalties paid by VCI was VIBV (a resident of the Netherlands Antilles at the relevant time) or VHBV (a resident of the Netherlands at the relevant time). The consequence of a determination that VIBV was the beneficial owner of VCI's royalty payments under the assignment agreements is that VCI would have been liable for Canadian withholding tax at the rate of 25 percent, rather than 10 percent, until the rate was reduced to 0 percent.

The CRA argued that the direct recipient of the royalties (VHBV) was merely an agent or a conduit regarding the flow of the royalty income, and did not exercise the incidences of ownership. Thus, the CRA found that VHBV was not the beneficial owner of the royalties, and therefore, the reduced withholding tax rate provided by the relevant treaty was not available.

The Tax Court turned to the *Prévost* definition of the beneficial owner of income as the person that receives the income for its own use and enjoyment and assumes the risk and control of the income it received. The court outlined four elements in considering the attribution of beneficial ownership: (a) possession, (b) use, (c) risk, and (d) control. In applying such a test, it upheld the statement in *Prévost* that a court is not likely to pierce the corporate veil unless the corporation has

⁴⁸ *The Queen v. Prévost Car Inc.*, 2009 FCA 57 (Feb. 26, 2009), paras. 14-15.

absolutely no discretion regarding the use and application of the funds. Associate Chief Justice Eugene P. Rossiter concluded that the taxpayer demonstrated it was the beneficial owner of the royalties based on each of the four above-mentioned elements, relying in particular on the following main factors:

- VHBV (not VIBV) had the legal right to receive the royalties from VCI;
- the funds paid as royalties by VCI were deposited in an account owned by VHBV, of which it had exclusive possession and control;
- those funds were commingled with other monies in VHBV's accounts, not held in a separate account;
- VHBV converted the funds from Canadian to U.S. dollars to pay VIBV (exposing itself to currency fluctuation risk);
- the money earned interest belonging to VHBV;
- VHBV did not have to seek instructions in dealing with the funds; and
- the amount of the royalty payments received from VCI differed from the amount paid by VHBV to VIBV.

That the royalty payments were commingled with other money in VHBV's accounts gave it discretion in the use of the funds, which therefore could be used by VHBV in any way it saw fit, according to the court. Rossiter pointed out that the royalties were treated as assets listed on VHBV's financial statements, making them available to creditors, with no priority given to VIBV as a creditor. Moreover, although VHBV was obligated to pay 90 percent of the royalties to VIBV, the funds actually paid were not necessarily the same as those received, meaning there was no automatic flow of specific funds because of the discretion of VHBV regarding the use of those funds (the other 10 percent were subject to the discretionary use, enjoyment, and control of VHBV).

The court further considered whether VHBV acted as an agent, nominee, or conduit regarding the royalties from VCI. Applying guidance found in the relevant OECD commentary, Rossiter concluded that VHBV was not acting as an agent for VIBV because it did not have the capacity to affect the legal position of VIBV. Moreover, VHBV could not be considered a nominee since it acted on its own account at all times, subject to the assignment agreements. Lastly, the court found no evidence that VHBV acted as a conduit of VIBV, since the limited discretion that VHBV exercised regarding the funds could suffice for beneficial owner status.

Accordingly, the court found that VHBV was the beneficial owner of the royalty payments made by VCI and was therefore entitled to the reduced withholding tax rate applicable to royalty payments under the Canada-Netherlands tax treaty.

That decision, by providing further clarification of the circumstances under which taxpayers can arrange

for payments to be made to a company in a treaty jurisdiction without the loss of treaty relief for Canadian-source payments, seems to highlight the limitations of attempting to use the beneficial ownership concept as a broad antiavoidance rule to address perceived treaty-shopping cases.

6. *ISS and Cyprus/Bermuda*

In December 2011 two separate cases on beneficial ownership were decided by two different appeals bodies in Denmark. In both cases, the decision was in favor of the taxpayer, exempting Danish companies from a requirement to withhold taxes on dividends totaling approximately \$1 billion.

The first case was decided December 20, 2011, by the Eastern High Court and concerned dividends paid from the Danish service conglomerate ISS to its Luxembourg holding company. While the Danish Ministry of Taxation decided not to appeal the decision of the high court, the second December 2011 decision, which was decided by the National Tax Tribunal on December 16, 2011, concerning dividends paid to a Cyprus holding company, has been appealed and is pending trial.

As a general rule, a Danish company is required to withhold taxes on the distribution of dividends and payment of intragroup interest, unless the recipient qualifies for an exemption under an EU directive or an income tax treaty. The Danish tax authorities maintain that this exemption is granted only if the recipient is the beneficial owner of the dividends.

a. ISS. The case concerned the issue of withholding tax liability on a dividend payment made in connection with the 2005 purchase by a group of investors (Goldman Sachs and EQT) of the Danish ISS Group through a Luxembourg holding company owned by limited liability partnerships based in Delaware, Guernsey, Germany, and Bermuda.

In the case, Danish company (HoldCo S A/S), through an acquisition structure commonly used by private equity funds in leveraged buyout transactions, paid dividends to its foreign parent (HoldCo H1 Sarl), and later, the parent lent a larger part of the dividends back to the Danish company. Concurrently, HoldCo S A/S effected a capital increase in one of its Danish subsidiaries by contributing the funds borrowed from HoldCo H1 Sarl. D2 then used those funds to acquire a third Danish company. At the end of the accounting year, the loan from HoldCo H1 Sarl to HoldCo S A/S was converted into stock of the latter.

The tax authorities claimed that the Danish company was liable for withholding tax on dividends distributed to its parent company in Luxembourg, since the recipient of that income did not qualify as the beneficial owner because it was, in the opinion of the tax authorities, a conduit entity.

The National Tax Tribunal did not agree and granted the company an exemption from the duty to withhold dividend taxes. Following the tax authorities'

appeal, on December 20, 2011, the high court found that the Danish definition of beneficial ownership must be interpreted in accordance with the international understanding of the concept and, specifically, with the definition provided by the commentary to the OECD model of 1977, as amended in 2003.⁴⁹ Further, the high court stated that if the intermediary holding company is not to be regarded as the beneficial owner, funds received must actually have been transferred further up in the structure, to recipients not qualifying for an exemption from withholding tax themselves. In the case, since the foreign parent company then returned the funds to the Danish company, partly as a loan and partly as a capital contribution, there was no doubt that the funds were meant to remain in the Danish company and were not to be redirected up in the corporate structure. In other words, since no funds were in fact passed on by the Luxembourg holding company, the company should be considered the beneficial owner of the dividends in question.

b. Cyprus/Bermuda. The case concerned a Danish subsidiary company (Denmark ApS) held by a U.S. group via holding companies in Cyprus and Bermuda. Denmark ApS was part of a large multinational group whose ultimate parent company was the listed USA Inc.

Until September 2005, the company was owned by Bermuda Ltd. Following intragroup restructurings in September 2005, Bermuda Ltd. established Cyprus Ltd. by inserting Cyprus between the Danish company and Bermuda Ltd.

In September 2005 and 2006 Denmark ApS distributed dividends to Cyprus Ltd. According to the Danish company, those funds were used to pay back the debt of Cyprus Ltd. to the parent company, Bermuda Ltd., from the purchase of the shares in Denmark ApS. Cyprus Ltd. was a traditional holding company with no functions other than that of owning shares. Cyprus Ltd. did not have any physical premises or staff.

⁴⁹The court found that the 2003 changes to the OECD commentary should be viewed as clarifications and, as such, should be taken into consideration in the interpretation of the notion of beneficial ownership used in older tax treaties. That said, the court stated that companies in which the management is authorized by corporate law to control the company, including dividends from underlying companies, cannot be disqualified as beneficial owner of the dividends. According to the court, that should also apply when one or more holding companies are interposed in a tax treaty state, but the ultimate owners of the holding companies are residents of a non-treaty state. In order to disregard such a holding company as the beneficial owner, the owner's control over the company must be above and beyond the planning and management at a group level that is normal in international groups. However, the court did not consider it relevant to apply the above-mentioned test in the case at hand, since any limitation of the exemption from withholding tax requires that the payment be made to recipients in a non-tax-treaty state.

The Danish tax authorities asserted that a withholding tax should be imposed on the Danish company, as the Cypriot holding company was not the beneficial owner of the above-mentioned dividends.

On December 16, 2011, the National Tax Tribunal ruled that based on the Cyprus-Denmark income tax treaty, Cyprus Ltd. should not be considered the beneficial owner of the dividends. The Tax Tribunal paid specific attention to the fact that the transactions were carried out between related parties and that the distribution was used to repay the debt to the Bermuda parent company and, further on to the ultimate U.S. parent company, in addition to the lack of physical premises, staff, and operating expenses in Cyprus.

However, the tribunal stated that under the EU parent-subsidiary directive (90/435/EEC), the Cyprus holding company was entitled to an exemption from the withholding requirement regardless of whether the company qualified as the beneficial owner. Under article 1(2) of the EU directive, the member states are not prevented from applying domestic legislation or treaties that are necessary to avoid fraud and abuse. The tribunal stated that although Denmark has not introduced specific provisions with this goal, the basis to disqualify legal transactions formally can be found under general principles of law, including case law. However, according to the tribunal, since the Danish Supreme Court has not allowed a reclassification of an existing company because the company was established to save tax, the Cyprus company, which was legally established and operating, should be considered the rightful recipient of the dividends distributed by the Danish company. Further, the fact that the only activity of the company was to hold shares in the Danish subsidiary should not lead to a different conclusion.

7. *Société Bank of Scotland*

The *Société Bank of Scotland* case involved the analysis of the beneficial owner requirement in light of the France-U.K. tax treaty of 1968. In 1992 Bank of Scotland (U.K. bank) entered into an agreement with a U.S. company (U.S. parent), whereby it acquired, for three years, usufruct over nonvoting preferred shares with a fixed dividend issued by the French fully owned subsidiary of the U.S. parent.

According to the agreement, the price paid by Bank of Scotland was to be recovered by the French company in the form of dividends over three years. In addition to a predetermined amount of dividends, Bank of Scotland would also receive a specific amount, calculated after the French withholding tax was applied and the French *avoir fiscal* was refunded to Bank of Scotland. The U.S. parent also undertook to pay the dividend amounts if the French subsidiary failed to do so, as well as additional compensation if the bank did not receive the refund of the *avoir fiscal*; buy back the shares if the income of the subsidiary did not reach a required threshold; and provide the French subsidiary with all financial support so that the latter could distribute the agreed dividends.

On payment of dividends from the French company, tax was withheld at the domestic withholding tax rate of 25 percent. Since under article 9(6) of the France-U.K. tax treaty, the rate of withholding tax on cross-border dividends was 15 percent, Bank of Scotland requested that the French tax authorities issue a refund of the portion paid in excess of that treaty rate and also asked for a tax credit under article 9(7) of the treaty.

The French tax administration (FTA) rejected the application on the grounds that the U.S. parent, rather than Bank of Scotland, was the beneficial owner of the dividend payments. The argument was that the case concerned a three-year loan agreement between Bank of Scotland and the U.S. parent, in which the U.K. bank, as payment, was granted access to obtaining an *avoir fiscal*.⁵⁰

The Paris Administrative Court of Appeal first ruled in favor of the taxpayer, stating that the transaction did not constitute an abuse of law because of the legal uncertainty of future distributions by the French subsidiary. Further, the court refused to qualify the transaction as a loan and declared that the France-U.K. tax treaty was applicable to dividends, because Bank of Scotland was a valid legal owner of temporary usufruct over the shares and therefore was directly entitled to the income.

Following the FTA's appeal, the French Supreme Administrative Court reversed the above decision, denying the France-U.K. tax treaty benefits to Bank of Scotland on the basis that the latter was not the beneficial owner of the dividends. The court held that the substance of the structure was a loan granted by Bank of Scotland to the U.S. parent, because the U.K. bank bore no equity risk regarding the French subsidiary. The court found that under the given agreement, Bank of Scotland had "too many guarantees, which reduced, in an unusual way, the risk a shareholder is supposed to bear." Thus, it concluded that the U.S. parent had merely delegated to its French subsidiary the reimbursement of the loan initially granted to Bank of Scotland. In reaching this conclusion, the court pointed out that the agreement in question was aimed solely at benefiting from the France-U.K. tax treaty, which provided the reduced tax rate and possibility of the *avoir fiscal* unavailable under the France-U.S. tax treaty of 1994.

Following the precedent provided by *Indofood*, the French Supreme Administrative Court clearly adopted an economic approach in determining the eligibility for

treaty protection. Unlike the *Indofood* case, however, in which attention was also given to the legal structure of the transaction, the reasoning of the French court was focused on the economic substance of the usufruct agreement⁵¹ and did not address the question of whether the notion of beneficial owner should be applied under an autonomous understanding or based on domestic law.⁵²

8. The Korean Cases

a. Lone Star Fund III (Bermuda) LP v. Director of Yeok-Sam Department of Revenue (2012 14 ITR 953). The plaintiffs, the U.S. limited partnership and Bermuda limited partnership, had invested in Korean real estate (that is, the Star Tower building) through an intermediate holding company (Star Holdings) in Belgium in order to obtain benefits under the Belgium-Korea tax treaty, which gives the country of residence taxing rights over capital gains from the sale of real property holding company shares. Later, when shares in Star Tower Co., Ltd. were sold, the Korean tax authorities viewed Star Holdings as a conduit organized for treaty shopping purposes and imposed individual income tax on the plaintiffs regarding capital gains from the sale. The Supreme Court, with a decision issued in January

⁵¹See Lee A. Sheppard, "Indofood and Bank of Scotland: Who Is the Beneficial Owner?" *Tax Notes Int'l*, Feb. 5, 2007, p. 406; and Xénia Legendre and Hicham Kabbaj, "Substance Over Form in France and the Bank of Scotland Decision," *Tax Notes Int'l*, Apr. 9, 2007, p. 171. Both authors underlined that this ruling constitutes evidence that the substance-over-form doctrine has finally come to France.

⁵²It has been observed that although it is not completely clear, it appears as though the French courts were concerned with ascertaining a domestic interpretation, in which, for example, reference is made to previous French administrative decisions:

The French administration has only on rare occasions taken a position on the impact of this concept. In an instruction of the 10 December 1972, 14 Be-2211, no 6, relating to the application of the Franco-Swiss treaty, it is stated that by apparent recipient is meant any person who does not have the real enjoyment of the income which it receives for the account of another person, whatever is the nature of the fiduciary relations existing between the first recipient of the income and the person who has the ultimate enjoyment, whatever may be the mode of transfer, direct or indirect, utilized for transmitting the income.

However, it has been pointed out that this reference could be no more than a form of autonomous international meaning, since it is suggested by the recognition that there is some common meaning among different countries:

The doctrinal analyses are united on the fact that the direct recipient of income is not entitled to obtain the advantages granted by international tax treaties if he is not the ultimate recipient of this income and he has only received it in the status of intermediary for another person to whom the income is destined to be transferred in one form and/or another.

See Craig Elliffe, "The Interpretation and Meaning of 'Beneficial Owner' in New Zealand," *Brit. Tax Rev.*, No. 3 (2009).

⁵⁰See Bruno Gibert and Yacine Ouamrane, "Beneficial Ownership — A French Perspective," *Eur. Tax'n* (Jan. 2008), p. 6. The price paid for the dividend coupons corresponded to the amount of the net dividends guaranteed to Bank of Scotland, before withholding tax, and the total amount of dividends to be paid, plus the refund of the *avoir fiscal*, was greater than the amount initially paid by the bank to acquire the usufruct of the shares.

2012, held that the substance-over-form doctrine is derived from the principle of equal taxation under the constitution. As a fundamental tax principle generally applicable under domestic tax law, it can be applied in interpreting terms of the Belgium-Korea tax treaty, to the extent the interpretation thereof is not contrary to the literal meaning of the treaty language. Finding that Star Holdings did not engage in any ordinary business activities in Belgium and was inserted solely for tax avoidance purposes in connection with the concerned investment activities in Korea, the Supreme Court concluded that Star Holdings was not the seller, in substance, under the Belgium-Korea tax treaty, since it only acted as a nominal party to the transactions in Korea, solely for the benefit of the original investors that should thus be treated as the real parties to the concerned transactions in Korea. The Supreme Court indicated that under the substance-over-form principle, the original investors that in substance owned the capital gains at issue should be subject to tax; thus, Star Holdings was not eligible for the benefits under the Belgium-Korea tax treaty. Meanwhile, regarding the tax authority's imposition of individual income tax on the plaintiffs, the limited partnerships (that is, not treating them as foreign corporations under the Corporate Income Tax Act), the Supreme Court held that a limited partnership under U.S. law is a for-profit organization that operates funds with its own investment purposes and holds separate assets distinguished from its owners', and thus should be treated as an entity separate from its owners with its own rights and duties. Therefore, it was held that a limited partnership should be taxed as a foreign corporation under the Corporate Income Tax Act, and the Supreme Court agreed with the lower court's finding that the imposition of individual income tax on the limited partnership was unlawful.

b. LaSalle Asia Recovery International LLP and Another v. Director of Jongno District Tax Office (Supreme Court Decision 2010 Doo 1948, April 26, 2012). On April 26, 2012, the Supreme Court rendered a decision in the case of *LaSalle Asia Recovery International LLP* involving two U.K. investment funds (collectively to be referred to as LaSalle). The investment exit took place in the form of the sale of shares in the Korean intermediate holding company (Northgate ABS SPC), and a capital gains tax exemption was claimed regarding gain from such share sale based on the Belgium-Korea tax treaty. The Korean holding company, by reason of its asset composition, may have constituted a real property holding company under Korean domestic tax law; however, the Belgium-Korea tax treaty does not contain specific provisions allowing Korea to tax shares in real property holding companies. LaSalle invested in the Korean commercial office building in 2002 through intermediate holding companies in Luxembourg, Belgium, and finally, Korea. The Belgium companies in the structure sold the shares in the Korean holding company, Northgate ABS SPC, in 2004 to a U.K. purchaser and derived capital gains. The Belgian companies claimed the

exemption for capital gains from the disposition of shares provided in the Belgium-Korea tax treaty, and the purchaser, in line with that position, did not withhold any tax on the share transfer. The National Tax Service (NTS) found LaSalle to be the beneficial owner and denied the exemption provided by the Belgium-Korea tax treaty. The NTS also imposed a penalty on the purchaser for failure to withhold taxes. The taxpayer appealed the assessment to the tax tribunal, the administrative court, and the high court in turn, but at each level the case was decided for the NTS. The taxpayer appealed to the Supreme Court, which upheld the NTS's view on the main issues below:

- *Whether the domestic law principle of substance over form will be applicable in determining whether tax treaty benefits apply.* The Supreme Court held that the principle is applicable in the interpretation of the tax treaty unless there is a provision specifically precluding its application.
- *Whether the enforcement decree under the Corporate Income Tax Act, providing for a seemingly broader definition than the Corporate Income Tax Act as to what constitutes a real property holding company, is valid.* The Supreme Court held the decree's definition of a real property holding company, which only specified the asset composition test, provides a broader definition than that specified in the decree under the Personal Income Tax Act, to be valid.
- *Whether the ground to waive the penalty for failure to withhold is valid.* The Supreme Court found that there was no ground to waive the penalty for failure to withhold taxes imposed on the purchaser. This case is meaningful in that the Supreme Court decision in *Lone Star* (January 27, 2012) confirmed the lower court's decision in general, but did not specifically address the application of the substance-over-form principle (provided in domestic tax laws) in the interpretation of a tax treaty. Regarding the issue of beneficial ownership in a fund structure generally, a new withholding procedure for claiming reduced withholding taxes under treaties took effect on July 1, 2012.

c. WiniaMando (Supreme Court 2010 Doo 25466, October 25, 2012). A Cayman Island fund organized in the form of a Cayman limited partnership (Cayman LP) established a Korean company (WiniaMando) underneath a series of holding companies, including Belgium NV. WiniaMando acquired and operated a business division from another Korean company. Belgium NV received dividend income from WiniaMando and also obtained capital gains income from the sale of shares in WiniaMando.

The taxpayer argued that Belgium NV should be respected as the substantive owner of the income, and therefore, the Belgium-Korea tax treaty should apply. It also argued that even if Belgium NV was only a conduit company, the ultimate investors in Cayman LP, rather than Cayman LP itself, should be considered the substantive owners of the income. The tax authority

took the position that since Belgium NV was only established as a conduit company to avoid tax, corporate income tax should be determined in reference to Cayman LP as the substantive owner of the dividends and capital gains income. The court held that since Cayman LP has an independent existence enabling it to act as a principal, with rights and obligations separate from that of its partners, it is a foreign corporation for Korean tax purposes. Belgium NV was party to the transaction only in form; therefore, the substantive owner of the income was Cayman LP. Further, the court rejected the plaintiff's argument that the ultimate investors in Cayman LP, rather than Cayman LP itself, should be taxed as the substantive owners.

d. Japan-Korea case (2012 du 24573, May 24, 2013). Korea's Supreme Court recently issued a decision in which it concluded that the term "beneficial ownership" as it relates to dividend income under the Japan-Korea tax treaty includes both direct and indirect ownership. The case involved a Korean company (Korea Co) wholly owned by a Labuan company (Labuan Co) that was, in turn, wholly owned by a Japanese company (Japan Co). On the grounds that Labuan Co, the direct shareholder of Korea Co, lacked substance, Korea Co regarded Japan Co as the beneficial owner of the dividends paid by Korea Co and, therefore, applied the tax treaty. Under the Japan-Korea tax treaty, the lower dividend withholding tax rate of 5 percent applies when the beneficial owner of dividends holds 25 percent or more of the voting shares of the dividend-paying company during the six-month period immediately before the end of the accounting period in which the distribution of the dividends takes place; the rate in all other cases is 15 percent. In the case, Korea Co (the withholding agent) withheld tax at the 5 percent rate on the dividends it distributed. The Korean tax authorities, however, assessed taxes in the amount of the difference between tax at the 15 percent rate and tax at the 5 percent rate, based on the interpretation that the ownership of shares under the treaty means only direct ownership. Therefore, Japan Co, which was an indirect shareholder of Korea Co, did not qualify for the lower 5 percent withholding tax rate. The Tax Tribunal agreed with the conclusion of the tax authorities, but in subsequent appeals, the administrative court and high court overturned the tribunal's decision and ruled that ownership of shares under the Japan-Korea tax treaty includes more than just direct ownership. The Supreme Court affirmed the decision of the high court. The high court had concluded that the purpose of the ownership clause is to minimize the potential for double taxation and promote cross-border investment. Since the potential for double taxation is more acute in the case of a company that holds 25 percent or more of the voting shares, such a company is provided with a lower withholding tax rate. The high court also added that because the treaty requires only that the beneficial owner "own" the shares and does not re-

quire the recipient to directly own the shares, the meaning of ownership should not be limited to direct ownership.

9. *China's Circular 601 and Subsequent Announcement 30*

In October 2009 China's State Administration of Taxation (SAT) issued Guoshuihan [2009] No. 601 (Circular 601) to clarify whether an entity can be regarded as the beneficial owner of an item of income according to China's income tax treaties.

In addition to the usual condition that the nonresident recipient of specific Chinese-source passive income must be a tax resident of the treaty partner state, Circular 601 requires that the nonresident recipient be the beneficial owner of that income in order to be entitled to treaty benefits under the relevant treaty with China. According to article 1 of the circular, a beneficial owner is defined as an entity or individual with ownership and control over income, or over the rights or assets that generate that income. The circular emphasizes that a beneficial owner must generally engage in substantive business activities, such as manufacturing, trading, or management activities.

Circular 601 further states that a conduit company cannot be regarded as a beneficial owner, referring to a company that is established with the goal of avoiding or reducing tax, or to transfer or accumulate profits. The circular clarifies that those companies are only registered in the country where they are located to satisfy legal organizational requirements and do not engage in any substantive operational activities. That provision seems to assume that conduit companies can never exist other than for tax avoidance purposes, with the result that they will therefore fail the beneficial owner test.

The circular makes it clear that the term "beneficial owner" should be analyzed and determined on a case-by-case basis, taking into account several facts and circumstances, and in accordance with the substance-over-form principle.

Moreover, Circular 601 sets out a series of adverse factors to be considered by the P.R.C. tax authorities in assessing whether the nonresident recipient is the beneficial owner. In particular, it mentions seven factors:

- the applicant is obliged to distribute most of its income (for example, more than 60 percent) within 12 months from the date of receipt;
- the applicant has no or minimal business activities other than the ownership of the assets or rights that generate the income;
- if the applicant is a corporation or other entity, its assets, scale of operations, and number of employees are not commensurate with its income;
- the applicant has no or minimal control or decision-making rights and does not bear any risks;
- the income of the applicant is nontaxable;

- for interest income, there is a loan or deposit contract between the applicant and a third party, the terms of which (that is, the amount, interest rate, and signing dates) are similar or close to those of the loan contract under which the interest income is received; and
- for royalty income, there is a license or transfer agreement between the applicant and a third party, the terms of which are similar to those under which the royalty income is received.

When claiming treaty benefits, a taxpayer is required to give the tax authorities documentation evidencing its beneficial ownership of the relevant income and that it does not fall within the scope of any of the above factors.

The SAT has delegated the assessment of the beneficial owner requirement to the local-level tax bureaus, although complex cases can be referred to the international tax department of the SAT.

Since uncertainties have arisen in practice regarding the manner in which the adverse factors are to be applied in the tax authority review,⁵³ on June 29, 2012, the SAT released an announcement (No. 30) providing further clarification on China's interpretation of the concept of beneficial owner.

One of the most important features of the announcement is the introduction of a safe harbor provision for the benefit of listed companies and their subsidiaries. This provision prescribes that the beneficial owner status of a company resident in a treaty country that derives dividend income from China can be confirmed without further verification, if the company is listed on a stock exchange in that treaty country, or is 100 percent controlled by a company that is listed on a stock exchange and is tax resident in the same treaty country. However, if the subsidiary is indirectly held by the listed parent through an intermediate holding company that is not a tax resident of the treaty partner state, this safe harbor will not be available.

Further, the announcement stresses the importance of considering the totality of factors in determining whether beneficial ownership exists, making particular reference to all relevant legal and financial documents, including articles of association, financial statements,

⁵³In particular, it has been unclear whether the status and substance of group companies can be taken into account in supporting an assertion of beneficial ownership by the treaty benefits claimant. Further, when the registered owner of equity interests in a P.R.C. company is merely an agent acting on behalf of the true beneficial owner, it is unclear whether the true beneficial owner could make the treaty relief claim itself. Finally, administrative difficulties have arisen because of variance in the treaty claims approval approaches adopted by local tax authorities and the need in some cases to obtain approval from multiple tax authorities in China.

board minutes and resolutions, functional analyses, legal contracts, asset ownership certificates, and invoice registers.

Finally, in addition to some explanations of administrative procedures, the announcement clarifies that when an agent or designated payee receives income in an agency or a nominee capacity for another party, it should not affect the identification of the true beneficial owner.

D. Italian Tax Rulings and Case Law

1. Resolution No. 107/E

On April 21, 2008, the Italian tax administration issued Resolution No. 167/E, addressing the tax treatment of payments made to a fiscally transparent Luxembourg fund for the final benefit of its investor, a Dutch pension fund exempt from tax in the Netherlands.

Under the facts of the ruling, the Luxembourg fund is fiscally transparent and not subject to tax in Luxembourg, and therefore, it does not qualify as a resident of that state for the purpose of the Italy-Luxembourg tax treaty. The Dutch pension fund is a separate entity under Dutch law, potentially subject to tax but actually exempt from it under a special tax regime applicable to pension funds. According to the Luxembourg fund's documents, the income of the fund is automatically transferred to the Dutch pension fund at least once a year without the need of any resolution by the fund's directors or management body.

The Italian tax administration ruled that the Dutch pension fund qualifies as both a resident and a beneficial owner of the income received through the Luxembourg funds, and therefore, was entitled to the benefits of the Italy-Netherlands tax treaty.

2. Resolution No. 86

The Italian tax administration on July 12, 2006, issued a ruling (Resolution No. 86) concerning the notion of beneficial ownership under the Italy-U.S. treaty in a back-to-back royalty arrangement in which a U.S. corporation acted as a licensing intermediary between non-U.S. patent owners and Italian licensees.

The administration found that the U.S. corporation acted merely as agent of the patent owner in licensing the patents to customers and collecting the royalties therefrom, without any control or power of disposition over the income, and therefore held that the Italy-U.S. treaty did not apply.

The facts of the ruling fully support this conclusion and can be summarized as follows.

The owners of various patents (26 companies organized in foreign countries) necessary to gain access to an international technology standard used primarily for the compression of video data, entered into an agreement among licensors, according to which they would license to customers all of their patents required for the use of the technology standard.

To facilitate the license of the patents to customers, the patent owners entered into an agreement with a U.S. corporation (license from licensor to licensing administrator), under which each owner granted to the U.S. corporation:

- a worldwide license for the use of the patents for the access to the technology standard and sale of the products obtained through the use of that technology standard; and
- the right to sublicense those patents to third parties.

For the use of the patents and sale of products to customers, the U.S. corporation would pay a royalty to the patent owners (determined according to different percentages, depending on the type and quantity of products sold and number of owners of the patents).

The sublicense of the patents to third-party licensees should be made based on standard contractual terms predetermined by the patent owners. The U.S. corporation, as administrator of the sublicensing contracts, collects the royalties from the third-party sublicensees and passes them on to the patent owners, in exchange for a fee — determined as a percentage of the royalties — for its administrative services.

The U.S. corporation acted only as an intermediary for the sublicense of the patents to third-party licensees (case b). It was not subject to tax in the U.S. on the royalties it collected on behalf of the patent owners that were taxable on the patent owners directly.

The tax administration referred to article 12 of the Italy-U.S. treaty and the 1977 version of the commentary to article 12 of the OECD model — setting out the international fiscal meaning of the term “beneficial owner” — as an authority for its conclusion that the U.S. corporation, having acted as an intermediary or agent for the patent owners, was not entitled to the benefits of the Italy-U.S. treaty.

It stated that the patent owners were the beneficial owners of the royalties, and therefore, any tax treaties between Italy and the patent owners’ country of residence would apply.

3. Resolution No. 104

In Resolution No. 104 of May 6, 1996, Italian tax authorities, in dealing with requests of refund of Italian withholding tax charged on dividends paid to banks and other financial intermediaries acting on behalf of nonresident investors, stated that the beneficial owners of the dividends, under tax treaties with the U.K., the Netherlands, and France, are those that are treated as the owners of the dividends and are taxed on the dividends in their state of residence.

4. Resolution No. 431

In Resolution No. 431 of May 7, 1987, the tax administration ruled that the Italy-U.S. tax treaty applies to Italian-source dividends paid to a U.K. bank that owns stock on behalf of U.S. pension funds, because the U.K. bank is an intermediary or agent of the pen-

sion funds for the purpose of collection of the dividends on the stock, and the pension funds are the beneficial owners of the dividends under article 10(2) of the Italy-U.S. tax treaty.

5. Turin Regional Tax Commission, Ruling 28/12/2012

On May 4, 2012, the Regional Tax Commission of Turin (an appellate tax court) issued an important decision concerning the burden of proof and evidence required to establish beneficial ownership of income and obtain access to treaty benefits.

In the case, the Italian Tax Commission was asked to decide whether the recipient of a royalty paid by an Italian company to a German company under an intellectual property sublicense agreement was the beneficial owner of the royalty entitled to the benefits of the Germany-Italy tax treaty, providing for a reduced 5 percent withholding tax rate.

The Italian company (sublicensee) entered into a sublicensing agreement with a German company (sublicensor) for the use of various intellectual property including patents, trade secrets, copyrights, know-how, and confidential information on a U.S. parent company (licensor). Under the sublicense agreement, the Italian company paid royalties to the German company and withheld taxes from royalty payments at the reduced 5 percent withholding rate, as provided for in the Germany-Italy tax treaty.

Before entering into the sublicense agreement, the Italian company (licensee) had entered into a license agreement, for the same purposes and under the same conditions, directly with the U.S. parent company (licensor), under which it had paid royalties to the U.S. company subject to a withholding tax of 10 percent under the Italy-U.S. tax treaty.

The Italian tax authorities argued that the German company was a mere conduit and that the U.S. company, rather than the German company, was the beneficial owner of the royalties, thereby denying the benefit of the lower withholding tax rate provided by the Germany-Italy treaty (as opposed to the 10 percent Italy-U.S. treaty withholding rate).

The Italian Tax Commission, even with the argument of the tax authorities, relied on the certificate, issued by the German tax authorities and produced by the taxpayer, stating that the German company was a tax resident of Germany subject to tax there, had accounted for the royalties as revenue in its financial accounting, and had filed its tax returns in German, reporting the royalties as taxable income, and therefore could be regarded as the beneficial owner of the royalties paid by the Italian company.

As a result, the Italian Tax Commission upheld the ruling issued by the tax court in the first instance proceedings (78/09/2010, dated June 14, 2010) and rejected the tax authorities’ assessment of additional withholding tax on the Italian payer of the income.

This ruling is important because the Italian Tax Commission reiterated the principle that a certificate issued by the tax authorities of a contracting state certifies that the recipient of the income invoking the benefits of the treaty is a tax resident of the treaty country and the beneficial owner of the income is sufficient, and finally, evidence that the beneficial ownership requirement is met and treaty benefits apply. According to the ruling, the beneficial ownership requirement is satisfied when the payment for which treaty benefits are sought is accounted for and reported as income by the recipient in its own country of residency.

It has been observed that this ruling represents a further acknowledgement of the general principle of sincere cooperation, as provided by article 5 of the EC Treaty (now article 10 of the EC Treaty). In this regard, the European Court of Justice pointed out that a certificate issued by the institution designated by the competent authority of one member state binds the competent institutions of a member state other than that under whose authority it was drawn up until it is withdrawn by the institution that issued it. The ECJ further stated that it is clear from article 5 of the EC Treaty that these obligations would not be fulfilled if the institutions of a member state were to consider that they were not bound by the certificate. Consequently, the certificate establishes a presumption that is binding on the competent institution of the member state concerned, since the opposite result would make it difficult to know which system is applicable and would therefore impair legal certainty.⁵⁴

6. Turin Regional Tax Commission, Ruling 15/06/12

On March 12, 2012, the Turin Regional Tax Commission issued another important decision for the taxpayer, stating that the burden of proving that the recipient is not the beneficial owner of income falls on the tax authorities.

By overruling the lower court,⁵⁵ the court of appeal held that the tax authorities cannot require further proof of beneficial ownership when the claimant has demonstrated that the recipient meets the requirements

⁵⁴ See Alessandro Furlan and Benedetto Colucci, "Il principio di 'sufficienza probatoria' a servizio del beneficiario effettivo," *Fiscalità e commercio internazionale*, No. 12/2012, p. 29. In particular, they make reference to the ECJ's Feb. 10, 2000, judgment in *Fitzwilliam Executive Search Ltd. v. Bestuur van het Landelijk instituut sociale verzekeringen* (C-202/97), in [2000] ECR I-00883. The ECJ specified that it is incumbent on the competent institution of the member state that issued the certificate to reconsider the grounds for its issue and, if necessary, withdraw the certificate if the competent institution of the other member state expresses doubts as to the correctness of the facts on which the certificate is based and, consequently, of the information therein.

⁵⁵ The Turin Provincial Tax Commission (Ruling No. 124 of Oct. 19, 2010) ruled for the tax authorities, stating that the claimant's arguments only proved that the Luxembourg company was the formal owner of the trademark and formally received the royalty payments, but not that it was the beneficial owner.

under Italy's domestic provisions implementing the EU interest and royalties directive, which provides an exemption from Italian withholding tax for qualifying royalties paid to an associated EU company.

In the case, the claimant was an Italian company that licensed a trademark owned by its parent, a Luxembourg company (Luxco) that is a wholly owned subsidiary of a Bermuda resident company. In 2004 the Italian company applied the reduced withholding tax rate of 10 percent on royalty payments to Luxco under article 12 of the Italy-Luxembourg tax treaty, rather than Italy's domestic withholding tax rate of 30 percent.

The Italian tax authorities claimed that Luxco was not the beneficial owner of the income, but rather a mere conduit collecting the income for the benefit of its ultimate Bermuda parent and, therefore, did not qualify for the benefit of the reduced rate under the treaty. As a result, in the opinion of the tax authorities, Italy's withholding tax rate of 30 percent should apply on royalties paid by the Italian company to its parent in Luxembourg.

The taxpayer argued that Luxco was the beneficial owner of the royalty payments based on the following factors:

- Luxco was the owner of the trademark, and the trademark was accounted for on its annual balance sheet;
- the income generated by the license agreement was properly accounted for in Luxco's profit and loss accounts;
- the trademark was properly registered in Luxembourg; and
- the permission to use the trademark was granted by a proper licensing agreement between the Italian company and its parent.

The lower tax court issued a decision for the tax authorities on October 19, 2010, noting that the taxpayer's argument only proved that Luxco was the formal owner of the trademark and formally received the royalty payments, not that it was actually the beneficial owner of the payments. In rejecting the taxpayer's position, the tax court argued that a beneficial owner must have a direct economic interest in the income and bear the entrepreneurial risks of its activities. According to the tax court, that test was not met because Luxco had acquired the trademark free of charge, had no costs associated with the trademark, and maintained a very limited operational structure (with no tangible assets and very limited personnel).

The court of appeal overruled the lower court, holding that the tax authorities must show that the recipient is a mere conduit and produce evidence to that effect — that is, the burden of proving that the recipient is not the beneficial owner of income falls on the tax authorities. The court of appeal found that the tax authorities had supported their position exclusively

through arguments focusing on the composition of Luxco's shareholder — that is, the Bermuda company — that there was neither evidence nor a reasonable presumption that Luxco was a pure conduit company, and that the evidence provided by the taxpayer had not been properly considered.

The court of appeal concluded that the claimant had provided sufficient evidence that Luxco would meet the requirements of the interest and royalties directive. The evidence showed that Luxco was subject to corporate income tax in Luxembourg, owned more than 25 percent of the Italian company's capital, and held the right to vote in that company's ordinary shareholders' meeting. Moreover, the court noted that the taxpayer had provided evidence that Luxco:

- incurred significant costs in purchasing the trademarks, such that it reported a loss for the relevant tax periods;
- paid a significant amount of VAT;
- was subject to the local statutory rules for corporations and prepared its financial statements in accordance with those rules;
- incurred salary costs and other operating expenses;
- owned a significant number of assets in addition to the trademark in question;
- incurred borrowing expenses for the acquisition of the trademark and paid taxes; and
- recorded significant revenue connected to its assets, including payments from third parties in addition to the royalties paid by the claimant for the trademark.

Consequently, the court of appeal concluded that the claimant had demonstrated that the recipient fulfilled all the requirements provided under Italian provisions implementing the interest and royalties directive, and as a result, it was also entitled to the benefits of the applicable tax treaty.

III. EU Interest and Royalties Directive

A. Overview

EU Directive 2003/49/EC of June 3, 2003 (entering into force from January 1, 2004) exempts interest and royalty payments between EU associated companies (or their PEs located in an EU member state) from any tax to be levied (either through withholding or assessment) in the state of source of the payment.

To qualify for the exemption, EU associated companies must meet the following requirements:

- they are organized according to one of the legal types listed in the annex to the directive;
- they are resident in an EU member state according to the tax law of that state, and are not to be considered resident outside the EU for tax pur-

poses under any tax treaties between that state and a third (non-EU) state;

- they are subject to corporate income tax in their state of residence; and
- they are connected through a minimum of 25 percent stock ownership in a parent-subsidiary or brother-sister relationship.

The stock ownership requirement is met if the payer owns directly at least 25 percent of the stock of the payee; the payee owns directly at least 25 percent of the stock of the payer; or a common EU parent (meeting the residency and legal form requirements set out above) owns directly at least 25 percent of the stock of both the payer and payee.

Member states can choose in their implementing legislation whether to measure stock ownership by vote or value (Italy chose vote).

A PE is defined as a fixed place of business situated in a member state through which the business of a company of another member state is wholly or partly carried on.

To be eligible for the exemption, the corporate payee (or its PE) must be the beneficial owner of the interest or royalty payment.

For interest or royalties paid between controlled companies, the exemption applies only to the extent that the amount is at arm's length. Any excess is subject to full withholding tax.

The directive also contains a general antiabuse provision according to which the member states are not prevented from applying their domestic provisions for the prevention of fraud or abuse, and can withdraw the benefits of the directive or refuse to apply them for transactions, the principal purpose or one of the principal purposes of which is tax evasion, avoidance, or abuse.

B. Directive's Definition of Beneficial Owner

The directive provides two different definitions of the term "beneficial owner," depending on whether the payee is a company or its PE.

The directive's definition of beneficial owner for corporate recipients is the following:

A company of a Member State shall be treated as the beneficial owner of interest or royalties only if it receives those payments *for its own benefit and not as an intermediary, such as an agent, trustee or authorized signatory*, for some other person. [Emphasis added.]

That test refers to the agent or intermediary situation and focuses on whether the corporate recipient acts on its own behalf, acquiring the legal title to the right or asset and the related income, or as an agent for another person who is the legal owner of the income concerned.

In this respect, it resembles the explanation provided in the commentary to the 1977 OECD model and

would accord beneficial ownership status to the recipient unless it acts in a strict agent/principal relationship on behalf of another person.

However, the phrase “its own benefit” might implicate a more substance-over-form analysis directed at investigating whether the company, in addition to being the legal owner of the income also has sufficient powers of enjoyment or disposition over the income, and has an economic return from the income, so that it can be considered the actual economic owner of the income.

The directive’s definition of beneficial owner for PEs is the following:

A permanent establishment shall be treated as the beneficial owner of interest or royalties:

If the debt-claim, right or use of information in respect of which interest or royalties payments arise is *effectively connected* with that permanent establishment, and

If the interest or royalty payments represent *income in respect of which that permanent establishment* is subject in the Member State in which it is situated to one of the taxes mentioned in Article 3(a)(iii). [Emphasis added.]

In this case, that test has two prongs: The PE must be the legal owner of the right or asset that generates the income, and the income must be attributed to the PE for tax purposes under the law of the state in which the PE is located.

Effective connection requires use of the right or the asset in the PE’s trade or business (that the right or asset is reflected on the PE’s books may not be sufficient in this respect).

That test more closely resembles the substance-over-form approach taken in the OECD conduit report and the explanations provided in the 2003 OECD commentary.

C. Italy’s Implementing Legislation

Italy implemented the directive by way of Legislative Decree No. 143 of May 30, 2005 (with retroactive effect to interest or royalties accrued from January 1, 2004).

In implementing the directive, Italy provided that the company or PE receiving the interest or royalties must be subject to tax on those payments (in the company’s state of residence or in the state where the PE is located).

Consequently, the exemption applies if the income payment is attributed to the recipient, for tax purposes, under the tax law of the state in which the recipient is a resident or is located.

The directive provides the specific subject-to-tax requirement only for interest or royalty payments made to PEs. By also imposing the subject-to-tax requirement for payments made to companies, Italian domestic leg-

islation strengthened the beneficial ownership requirement as it applies to companies.

Italy has implemented the general antiabuse clause of the directive by amending its domestic antiavoidance rules, which now apply also to interest and royalties paid to companies that are directly or indirectly controlled by persons that are not residents in the EU.

Under the revised antiavoidance rules, the exemption would be denied and full tax would be withheld, if a transaction lacks economic substance and is part of a scheme whose purpose is to benefit from the exemption that would not otherwise be due.

D. Italy’s Administrative Guidance

1. Circular 47/E

Italy’s tax administration has provided guidance on the interpretation and application of the interest and royalties exemption by way of Ministerial Circular No. 47/E of November 2, 2005.

The circular states that the specific subject-to-tax requirement also prescribed for the interest and royalty payments made to companies is in compliance with the directive, which (in preamble 3) clarifies that “it is necessary to [ensure] that interest and royalties are subject to tax once in a Member State.”

Circular 47/E also provides important clarifications on the interpretation and meaning of the term “beneficial owner.” It states that to be considered the beneficial owner of a payment, a company must receive the payment as the ultimate beneficiary, not as an intermediary, such as an agent, fiduciary, or collector of the payment for another person.

More importantly, it clarifies that in practical terms, in order for a company to be considered the final beneficiary of the interest or royalties, it is necessary that the company receiving the interest or royalties derive a direct personal economic benefit from the income from the transaction, considering that the function of the requirement is to prevent the use of an intermediary solely for the purpose of benefiting from the exemption.

The circular states that considering the antiabuse purpose of the beneficial ownership clause, a company will be treated as beneficial owner of the income if it has the power of realization and disposition of the income concerned.

The personal economic benefit and power of disposition standards clearly recall the very narrow powers and benefit standards of the OECD conduit report and 2003 commentary.

Regarding interest and royalties received by PEs, the circular confirms that beneficial owner status requires that the right or property generating the income be effectively connected to the PE — that is, be held and used by the PE in the conduct of its trade or business — and that income received regarding that right or property be included in the PE’s income subject to tax in the state where the PE is located.

If the income is not attributed to the PE and is subject to tax under the laws of the state where the PE is located, there would be no risk of double taxation, and therefore, Italy as the source state would be free to charge its full withholding tax on that income.

2. *Circular No. 41/E*

The tax administration in Circular 41/E of August 5, 2011, further clarified that the recipient of the interest or royalty payments qualifies as beneficial owner to eliminate the withholding tax under the directive, if it enjoys a direct economic benefit from the transaction as a result of having the legal right to and power of disposition of the payments.

IV. EU Savings Income Directive

EU Directive 2003/48/EC of June 2, 2003 (to be implemented by member states by January 1, 2004), provides for an automatic exchange of information system to ensure that savings income in the form of interest earned by a resident of a member state from sources in another member state is taxed in the recipient's state of residence. Italy implemented the directive by way of Legislative Decree No. 84 of April 18, 2005.

Under that system, a paying agent (bank or financial institution) established in a EU member state that secures an interest payment for an individual who is resident in another EU member state must provide to the tax authority of the state from which that payment originates specific information on the recipient, which is passed on to the tax authority of the recipient's state of residence where the tax is ultimately expected to be levied.

States that are exempted from the exchange of information charge a backup withholding tax, whose proceeds are shared 25/75 with the recipient's residence state, which, in turn, grants a credit for the full amount of the withholding tax.

The directive applies if the beneficial owner of the interest payment is resident in an EU member state.

Beneficial owner is defined in the directive and Italian implementing legislation as any individual receiving the payment for his own benefit and as final beneficiary of the income.

Circular 55/E of December 30, 2005, which provides guidance on the application of the legislation implementing the directive, confirms that the beneficial owner is a person who receives the payment for his own benefit.

V. Italian Portfolio Income Exemption

Italian law exempts nonresidents from the gross basis 12.5 percent tax on interest paid on bonds issued by Italian banks, publicly listed companies, central and local governments and state agencies, securitization special purpose vehicles, and joint stock companies organized as a result of privatization of state-controlled conglomerates.

The exemption applies also to income derived from collective investment funds, gains from the sale of portfolio stock in Italian companies, income from derivative transactions, income from securities lending and sale and repurchase agreements carried out in Italy, and other types of Italian-source portfolio income.

The exemption is granted to investors resident in foreign countries that maintain an exchange of information system with Italy and are included in a special list (the so-called white list), if the nonresident person that claims the exemption is the beneficial owner of the income.

Ministerial Circular No. 306/E of December 23, 1996, states that the beneficial owner of the income is the person to whom the income is attributed for tax purposes under foreign law and refers to the OECD commentary in support of the proposition that the requirement is not satisfied when an intermediary, such as an agent or nominee, is interposed between the debtor and the final beneficiary of the income.

The exemption is granted also to foreign regulated investment companies such as pension and mutual funds, and to unregulated investment companies like private equity or hedge funds and trusts that are treated as partnerships (that is, fiscally transparent entities) in their country of organization.

To qualify for the exemption, foreign funds, even if transparent under foreign law, are treated as residents in their country of organization and as the beneficial owners of the income.

Therefore, the white list and beneficial owner requirements are tested at the level of the fund, rather than at the level of the fund's individual investors.

The exemption is denied to closely held funds organized solely for managing investments of a limited number of investors, even if their statutory purpose is managing investments, and to trusts and partnerships that have been formed to enable their investors, who would not otherwise qualify for the exemption, to benefit from it.

To benefit from the exemption, the nonresident investor must provide the debtor or payer with a certificate of tax residency issued by the tax administration of his country of residence, and an automatic certification statement attesting that he is the beneficial owner of the income and satisfies all other requirements for the exemption, also providing all of his personal information and contact details.

VI. EU Parent-Subsidiary Directive

The EU parent-subsidiary directive — which exempts from withholding tax the dividends paid by an EU subsidiary company to its EU parent — does not contain a beneficial ownership requirement.

Italy included in its domestic implementing legislation an antiabuse provision according to which the exemption does not apply to EU parent companies that

are directly or indirectly controlled by one or more non-EU residents, unless satisfactory evidence is provided by the taxpayer that the parent company has not been set up for the exclusive or principal purpose of benefiting from the exemption granted by the directive.

VII. Italian Domestic Antiavoidance Rules

A. General Antiabuse Doctrine

In *Halifax*,⁵⁶ the taxpayer (a U.K. financial entity) used some of its subsidiaries as intermediaries for carrying out a real estate development project, in order to be able to deduct input VAT charged by its suppliers on construction services, which it would not have been able to claim, had it carried out the transaction directly.

The ECJ ruled that the input VAT credit was not available to the taxpayer because the essential goal of the transaction was to obtain a tax advantage. It also stated that the right under EU law to deduct input VAT could not be extended to cover abusive practices or “transactions carried out not in the context of normal commercial operations, but solely for the purpose of wrongfully obtaining advantages provided for by Community Law.” The Italian Supreme Court interpreted this decision as a general antiabuse doctrine that can be used for interpreting and applying domestic tax laws intended to prevent tax avoidance. The court also relied on it as additional authority in support of two decisions in which it considered null and void under a general anti-fraud statute and denied tax effects to transactions entered into for the sole purpose of avoiding income taxes.

Both cases concerned dividend washing transactions.

In the first case (Ruling No. 20398 of October 21, 2005), an investment fund sold stock of an Italian company to another Italian company after a dividend had been declared but before the dividend was distributed, at a price equal to the value of the stock plus the amount of the dividend.

The purchaser collected the dividend and immediately thereafter (under a prearranged plan) sold the stock back to the fund, realizing a loss.

According to the law in effect at the time of the facts, the dividend, if paid to the fund, would have been subject to a gross basis withholding tax, while any gain realized by the fund through the sale of the stock at a price that included the amount of the dividend was not taxable to the fund.

The dividend collected by the purchasing company was taxable income for the purchaser, but the tax was eliminated by the imputation credit granted to the pur-

chaser equal to the tax paid by the distributing company on the profits out of which the dividend had been distributed.

Therefore, the sole result of the transaction was avoiding the dividend withholding tax on the fund and providing the purchaser with a loss that could offset other income. The transaction did not provide the opportunity for any economic profit or loss for the parties.

Tax law in effect at the time of the facts did not contain any antiavoidance provisions that could challenge that type of transaction.⁵⁷

The Supreme Court, reversing its prior decisions on this issue, ruled that the case must be tested on the face of the abuse of tax law doctrine developed at the EU level, as elaborated by the ECJ in its recent decision in *Halifax*, which constitutes an underlying tax doctrine also displaying effects at the national law level.

According to the Court, the abuse of law doctrine compelled the Court to find legal remedies within the domestic law to disregard transactions designed only to avoid taxes. The Court found those remedies in the general provisions of Italian Civil Code that establish that a contractual agreement is null and void if it lacks valid consideration — that is, it does not have economic substance — and is used to circumvent binding provisions of law.

Under those provisions, the Court held that the arrangement was abusive and should be disregarded, and it treated the purchaser as a mere agent of the fund in collecting the dividend payment. The dividend income and capital loss realized by the purchaser of the stock were ignored, and the dividend was subject to withholding tax as if it had been actually paid to the fund.

The second case (Ruling No. 22932 of November 14, 2005) presents facts similar to those of the previous one, except the owner of the stock was a foreign person. He granted a usufruct right on the stock to an Italian company in exchange for a payment equal to the amount of the dividend declared on the stock.

The Italian company collected the dividend and received a credit equal to the tax paid by the distributing company on the underlying profits that offset the tax on the dividend (under the old imputation system).

The foreign person was not subject to withholding tax on the dividend substitute payment received under the usufruct agreement, which was treated as the purchase price of the stock.

Under the abuse of law doctrine and domestic civil law provisions that disregard transactions lacking valid consideration and carried out in fraud of the law, the Court disregarded the transaction as abusive and held

⁵⁶*Halifax PLC et al. v. Commissioners of Customs and Excise* (C-255/02), Feb. 21, 2006.

⁵⁷Article 37-bis of Presidential Decree No. 600 of Sept. 29, 1973, which most likely would have struck down that transaction, was enacted later.

that the dividend was subject to withholding tax as if it had been paid directly to the foreign person.

With Order No. 21371 of October 4, 2006, the Supreme Court asked the ECJ to clarify whether its anti-abuse test in *Halifax* is a sole purpose test or a main purpose test⁵⁸ in a similar case involving an abuse of input VAT credit. In particular, the dispute in the main proceedings regarded the artificial division of several linked contracts designed to reduce the VAT burden to a lesser amount than that from an ordinary leasing contract, since tax is levied only on the granting of the use of the vehicle, the cost of which is almost equivalent to the purchase price of that vehicle. It was therefore necessary to determine whether the fact that a financing transaction — regarded in economic practice and in national case law as an essential component of a leasing contract — that is regulated by a separate contract concerning the granting of the use of the goods can constitute an abuse of rights or legal form according to the definition given by community case law. The referring court asked whether the Sixth Council Directive 77/388/EEC should be interpreted as meaning that there can be a finding of an abusive practice when the accrual of a tax advantage is the principal goal of the transaction or the transactions in question, or if such a finding can only be made if the accrual of that tax advantage constitutes the sole goal pursued, to the exclusion of other economic objectives.

The ECJ observed that in the dispute in the main proceedings, the exemptions from VAT were under scrutiny and that specifically, in connection with those exemptions, article 13 of the Sixth Directive requires member states to prevent any possible evasion, avoidance or abuse.⁵⁹

The ECJ pointed out that in paragraphs 74 and 75 of *Halifax and Others*, the Court first held that in interpreting the Sixth Directive, an abusive practice can be held to exist when:

- the transactions concerned, notwithstanding formal application of the conditions laid down by the relevant provisions of the Sixth Directive and the national legislation transposing it, result in the accrual of a tax advantage, the grant of which would be contrary to the purpose of those provisions; and
- it is apparent from a number of objective factors that the essential goal of the transactions concerned is to obtain a tax advantage.

⁵⁸For a discussion of Italian Supreme Court Order No. 21371 and its implications under Italian tax law, see Marco Rossi, “Italian Supreme Court Wants Clarity on *Halifax* Test,” *Tax Notes Int'l*, Dec. 4, 2006, p. 735.

⁵⁹Judgment of the Court (Second Chamber) of Feb. 21, 2008 (C-425/06), *Ministero dell'Economia e delle Finanze v. Part Service Srl*, [2008] ECR I-00897.

Further, the ECJ noted that, in paragraph 81 of *Halifax and Others*, the Court once again referred to transactions seeking to obtain a tax advantage, while providing the referring court with details for guidance in interpreting the transactions in the case in the main proceedings.

In light of the above, the ECJ concluded that:

Therefore, when it stated, in paragraph 82 of that judgment, that in any event, the transactions at issue had the sole purpose of obtaining a tax advantage, it was not establishing that circumstance as a condition for the existence of an abusive practice, but simply pointing out that, in the matter before the referring court in that case, the minimum threshold for classifying a practice as abusive had been passed. The reply to the first question therefore is that the Sixth Directive must be interpreted as meaning that there can be a finding of an abusive practice when the accrual of a tax advantage constitutes the principal aim of the transaction or transactions at issue.

In order to determine whether applying the VAT, the actions of the relevant parties, having regard to their reciprocal links, can constitute an abusive practice under the Sixth Directive. The ECJ pointed out that in some circumstances, several formally distinct services must be considered to be a single transaction when they are not independent. According to the Court, that is the case when two or more elements or acts supplied by the taxable person to the customer are so closely linked that they form a single, indivisible economic supply, which would be artificial to split.

Further, the ECJ provided the referring court with evidence of the existence of an abusive practice as follows:

- the two companies taking part in the leasing transaction are part of the same group;
- the service supplied by the leasing company (IFIM) is subject to a division — the financing element is entrusted to another company (Italservice), to be split into a credit service, an insurance service, and a brokerage service;
- the service of the leasing company is therefore reduced to renting a vehicle;
- the lease payments made by the customer are of an amount which is only slightly higher than the purchase cost of the vehicle;
- that service, considered in isolation, therefore seems to be economically unprofitable, so the viability of the business cannot be ensured solely by means of contracts concluded with the customers; and
- the leasing company receives the consideration for the leasing transaction only through the cumulative lease payments made by the customer and the amounts transferred from the other company of the same group.

The ECJ lastly ruled that in order to assess whether the transactions concerned can be held to constitute an abusive practice, the national court must first verify whether the result sought is a tax advantage, the granting of which would be contrary to one or more of the objectives of the Sixth Directive, and then whether that constituted the principal goal of the contractual approach adopted.

B. Statutory Antiavoidance Provisions

Article 37-*bis* of Presidential Decree No. 600 of September 29, 1973, contains the most important Italian statutory antiavoidance provisions.

They apply to specific transactions listed therein, which include corporate mergers, acquisitions, divisions (spinoffs, split-offs, and split-ups), liquidations, and equity distributions; contributions and transfers of businesses (going concerns); the assignment of tax credits and excess taxes; transfer and financial statement classification of stock or other assets that may be eligible for the participation exemption; the transfer of assets by affiliated companies filing a consolidated tax return; and interest and royalty payments between associated companies eligible for exemption under the EU interest and royalties directive.

The provisions apply to a transaction (or a series of transactions that are part of a scheme) that lacks economic substance, carried out to avoid tax obligations and obtain undue tax benefits. In this case, the tax administration can disregard the tax effects of the abusive transaction or transactions and apply the taxes that would have been due in the absence of tax avoidance.

Before challenging the tax avoidance transaction and assessing additional taxes, the tax authority must issue a notice to the taxpayer in which it sets forth the legal grounds for the challenge and asks for additional clarification on the nontax reasons of the transaction.

Taxpayers can apply for a ruling if they seek prior approval of a transaction under the tax avoidance provisions.

C. Statutory Anti-Conduit Rules

Article 37 of Presidential Decree No. 600/1973 provides that during audits or while assessing additional tax liability, tax authorities can treat a person as the real owner of income of which other persons appear to be the formal owners, if it is proved, by way of presumptions, that the first person is the real possessor and beneficiary of the income through those other persons.

The above provision must be read in combination with the substantive provision of article 1 of the Italian Tax Code, according to which the subject matter of income tax is the possession of income falling into one of the categories of income listed in article 1.

Possession of income means beneficial (economic) ownership of the income, as opposed to mere legal title to it.

The tax administration has tried to use the above provisions as broad anti-conduit or antiavoidance rules.

The Supreme Court has taken the position that the provisions apply only in narrower circumstances — that is, only in case of fictitious interposition by way of simulation. The concept of contractual simulation is governed by the civil code and arises when the parties enter into an official contract and, at the same time, stipulate in a side letter or confidential agreement the real terms of their arrangement, and appoint other persons to carry out a transaction as undisclosed intermediaries or agents.⁶⁰

D. Substituted Income Rule

Article 6(2) of the Tax Code provides that income earned in substitution of other income, and indemnities obtained as damages for loss of income, retain the same tax character as that of the income substituted or lost.

Under the above provision, the tax administration can challenge transactions used to convert or change the character of income in order to obtain a more favorable tax treatment.

E. Cross-Border Antiavoidance Provisions

Tax avoidance provisions have been enacted recently for outbound investments.

Under new anti-inversion residency provisions, a foreign nonresident entity is treated as resident in Italy for tax purposes, and is subject to tax in Italy on its worldwide income, if it is controlled by Italian resident shareholders or managed by Italian resident directors.

Taxpayers can avoid the application of the rules if they demonstrate that the place of effective management and control of the entity is outside Italy.

Foreign investors in Italy through joint ventures in which Italian residents retain significant control, power, or stock ownership must be aware that they may be exposed to greater tax liability as a result of the above rules.

A look-through rule applies to determine whether foreign-source dividends are eligible for the participation exemption. Dividends are ineligible if they come from companies organized in a blacklisted jurisdiction. The term “come from” establishes the look-through rule, under which dividends distributed by qualifying foreign companies are subject to tax, if and to the extent that they are paid out of profits that the distributing company received from companies located in a blacklisted jurisdiction, which does not qualify for the exemption.

F. Codification of a GAAR

The uncertainty regarding these statutory antiavoidance provisions led to the approval, in October 2012,

⁶⁰Corte di Cassazione, Judgment No. 8161 of Oct. 21, 1994.

of a project of law for the reform of the Italian tax system. Article 3(1) provides guidelines to be followed by the government in defining the concept of “abusive practice.” In particular, according to the guidelines, there can be a finding of an abusive practice when the accrual of a tax advantage constitutes the principal goal of the transaction or transactions concerned.

The codification of the meaning of abusive practice beyond the specific transactions listed in article 37-*bis* of Presidential Decree No. 600/73 is in line with the recent U.S. approach to the issue.

Following the codification of the economic substance doctrine as a general principle, the tax authorities will have greater ability to deny the anticipated tax benefits from a transaction not resulting in a meaningful change to the taxpayer’s economic position other than reducing federal income taxes, even if the transaction otherwise satisfies all statutory and administrative requirements.

G. Domestic Antiavoidance Provisions, Treaties

The relationship between tax treaties and domestic antiavoidance rules and the applicability of these rules to the treaties are particularly complex matters. The 2010 commentary to article 1 of the OECD model discusses them at paragraphs 7-10.

From an Italian perspective, one can see that under Italian constitutional law, tax treaty provisions constitute international law and rank at the highest level in the Italian system of sources of law (second only to the Italian Constitution). As such, they prevail over national law.

Also, tax treaties contain special provisions that limit the taxing power of the two contracting states in the specific matters covered by the treaty. Because a specific law prevails over a general law, treaties should prevail over domestic law.

Finally, the circumstance that some treaties contain a general antiabuse provision (as in Italy’s treaties with Estonia and Lithuania) or a special antiabuse provision (as in Italy’s pending treaty with the U.S.) offers a strong argument that in the absence of those provisions in a given treaty, domestic antiavoidance rules should not apply.

This view is further supported by the fact that tax treaties are international agreements, and a common interpretative rule is that the parties to an agreement cannot be bound by terms that they have not negotiated or agreed upon and are not in the agreement itself.

At the same time, there are valid arguments that domestic antiabuse provisions should always apply, even for matters covered by treaties.

According to the Italian Supreme Court, treaty provisions are conflict of law rules that do not institute or regulate taxes in lieu of the domestic tax laws of the contracting states, but allocate the power to tax specific items of income between the contracting states. Even

when a treaty applies, taxes continue to be applied in accordance with the domestic law of the two contracting states.⁶¹ Under this approach, a treaty abuse ends up being an abuse of domestic tax law, and there is no reason why domestic antiabuse provisions should not apply.

Also, domestic rules on characterization of the transaction or determination of the taxpayer that is treated as deriving the income do not conflict with tax treaties, which takes into account the way in which the transaction is treated under the domestic tax law of the contracting states.

Therefore, to the extent that domestic antiavoidance rules result in recharacterization of income or redetermination of the person that is treated as the taxpayer regarding a particular transaction, treaties should not interfere and should take into account those changes.⁶²

Even if they do not apply directly to tax treaty matters, domestic antiabuse provisions like the ones noted above can be used as means of interpretation of express or implied antiabuse provisions in tax treaties.

VIII. Conclusion

The concept of beneficial ownership applies in different contexts under Italian international tax law.

Two areas in which it serves a substantially similar function are tax treaties and the EU interest and royalties directive.

In both, the taxpayer must be the beneficial owner of the income to get relief (elimination or reduction) from the withholding tax on the income in the state of source.

In implementing the EU interest and royalties directive and interpreting the meaning of the term “beneficial ownership” therein, Italy has adopted the position that beneficial ownership requires the power of enjoyment and disposal of the income, which the taxpayer must receive for his own benefit, and taxation of the income in his residence state.

That interpretation is consistent with the definition of beneficial ownership in the Germany-Italy tax treaty (the only one of Italy’s 77 tax treaties in force that contains a definition of that term).

It is also consistent with the interpretation of beneficial ownership offered by the 2010 commentary to the OECD model. According to the commentary, the term “beneficial owner” is not used in a narrow technical sense but must be understood in its context and in light of the object and purpose of the model treaty, which includes the avoidance of double taxation and prevention of tax evasion and treaty abuse.

⁶¹Supreme Court Judgment No. 1122 of Feb. 2, 2000.

⁶²See 2010 commentary to article 1 of the OECD model, para. 22.

If the immediate recipient of the income is not treated as the owner of the income and, therefore, is subject to tax on that income in his state of residence, or, despite being treated as such, he passes on the income to a non-treaty-partner jurisdiction in a back-to-back transaction in which he has no power of disposition of the income and does not retain any economic benefit regarding the receipt of that income (acting more like an administrator or fiduciary on account of the final beneficiary of the income), the recipient cannot be treated as the beneficial owner of the income and the treaty benefits should not be available.

In light of the above, the beneficial ownership concept appears to be interpreted as an antiabuse provision designed to prevent treaty and EU law shopping.

Domestic antiavoidance provisions designed to prevent similar abuses, and the recent approach taken by the Italian tax administration and courts that substance should prevail over form in the analysis of transactions designed to achieve favorable tax treatment provide further support to the above interpretation.

Of course, the determination whether the taxpayer has a real power of disposition of the income and receives it for his own benefit is factual and depends on the circumstances of the case.

It can be argued that the recent decision of the U.K. Court of Appeal in *Indofood* has brought the concept of beneficial ownership too far.

Until that decision, the conventional wisdom was that as long as a financial subsidiary earned a spread in the transaction, treaty benefits were due, subject to any LOB provision included in the relevant treaty.

Indofood would seem to suggest otherwise. It applied the beneficial owner requirement according to its international fiscal meaning and held that no treaty benefits would be available when the financial subsidiary earned a profit and satisfied substance requirements under its home country's law. If picked up in other jurisdictions, that decision could provide to tax authorities a golden opportunity to challenge structured finance transactions or back-to-back license arrangements that so far have been considered safe.

However, the recent case law seems to challenge the interpretation of the beneficial owner requirement in the landmark *Indofood* case. The Canadian⁶³ and Danish⁶⁴ cases discussed above represent a different ap-

proach in the interpretation and application of the concept in that they disregard the substance-over-form principle. In interpreting the relevant tax treaties, these rulings rely on the domestic meaning of beneficial owner and, consequently, reject the tax authorities' attempt to turn the definition into an antiavoidance tool, beyond its original limited purpose. In avoidance with a formalistic approach, Canadian and Danish courts seem to focus primarily on the legal form of the transactions concerned, making it clear that a holding company is regarded as the beneficial owner of its property and, as such, is entitled to the tax benefits provided by a bilateral treaty, even though the company may not have a physical office or employees.

The Italian tax decisions issued in 2012 seem to further support the taxpayer's position and stand for the principle that in the absence of strong evidence that the recipient of the income is not the actual beneficial owner of it — which falls upon the tax authorities to provide — treaty benefits should be granted.

Despite the lack of an international tax law meaning of beneficial ownership, it would seem that an autonomous international meaning is preferred among most international tax law commentators.⁶⁵ The disadvantage when interpreting with reference to domestic law is that different conclusions are reached in the two states if each state applies its own understanding of domestic law, and domestic law frequently contains no definition.⁶⁶ There is a general consensus in international tax law literature that the notion of beneficial owner makes it possible to attach importance to the actual rather than formal ownership.⁶⁷ However, a search for a more precise definition of the notion is frequently in vain.

importance in Danish tax treaties, because it is possible to fulfill the requirement of beneficial ownership by observing the necessary legal formalities. See Aage Michelsen, *International skatteret* (2003), p. 427; Steen Askholdt, *Cahiers de droit fiscal international* (1987), p. 281; Henrik Calum Nielsen, *R&R* (1986), p. 304; Nikolaj Bjornholm and Anders Oreby Hansen, *Lempelse af dobbeltbeskatning* (2002), p. 449; and Jorn Quiste and John F. Avery Jones, *R&R* (1985), p. 241.

⁶⁵See, however, Joanna Wheeler, *Cahiers de Droit Fiscal International*, Vol. 92b (2007), p. 27, in which the results of the comparative survey have been summarized so as to imply considerable variation in the way the notion is interpreted in the various reporting countries.

⁶⁶However, an autonomous interpretation of a notion can also lead to different conclusions when a notion does not let itself be determined by use of international sources of law, or when the content of the notion remains unclear because international sources of law lead to no clear interpretation. See Jakob Bundgaard and Niels Winther-Sørensen, "Beneficial Ownership in International Financing Structures," *Tax Notes Int'l*, May 19, 2008, p. 587.

⁶⁷See Klaus Vogel, *Doppelbesteuerungsabkommen Kommentar*, 4th ed. (2003), Vor Art. 10-12, Margin No. 15; Charl P. du Toit, *Beneficial Ownership of Royalties in Bilateral Tax Treaties* (1999), p. 177; Jerry Libin, *Bulletin* (2000), p. 310; and Marjaana Helminen,

(Footnote continued in next column.)

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⁶³It has been observed that Canadian courts understood that treaties are contracts and held the government to its bargain, however undesirable the result. The rulings concerned basically said that treaty shopping was not abusive. See Lee A. Sheppard, "Beneficial Ownership Too Onerous," *Tax Notes Int'l*, Sept. 22, 2008, p. 999.

⁶⁴Also Danish tax law literature has held the view that a definition of "beneficial owner" in accordance with domestic law is applicable under article 3 of the model treaty. A number of authors have stated that the notion of beneficial owner has little

According to the OECD Committee on Fiscal Affairs, the above-mentioned 2011 and 2012 discussion drafts are specifically designed to clarify the interpretation that should be given to the concept of beneficial owner in the OECD model, in order to avoid the risks of double taxation and nontaxation resulting from those different interpretations. However, this proposal to amend the OECD commentary has been largely criticized, in that it appears to be an attempt to broaden the scope of the meaning of the beneficial owner requirement in articles 10, 11, and 12 of the model to address some perceived, but not clearly stated, antiavoidance concerns. A review of the comments from all interested parties indicates that many are critical of the uncertainty that would result if the proposed changes were to be adopted and, more generally, of the use of the beneficial ownership concept as an antiabuse rule.⁶⁸

Eur'n Tax'n (2002), p. 454. However, some authors have maintained that when referring to article 3(2), domestic tax law should be included in the determination of the notion. See Wim Eynattan, Kurt De Haen, and Niko Hostyn, *Intertax* (2003), pp. 523, 538, and 546; and Hans Pijl, *Intertax* (2003), p. 353.

⁶⁸On this issue, see Bundgaard and Winther-Sørensen, *supra* note 66, in which they state:

The notion of beneficial owner in articles 10-12 of the OECD model treaty may be viewed as antiabuse rules, unless the recipient of dividends, interest, or royalties is the beneficial owner. In the OECD commentary to article 1, the notion of beneficial owner is mentioned in relation to a general discussion on abuse of tax treaties; the notion of beneficial owner is used as an example of a special provision aimed at one type of tax avoidance. The correlation between the notion of beneficial owner and general considerations regarding abuse may give rise to several questions that partly relate to treaties that do not include the notion of beneficial owner and partly to treaties that contain the notion of beneficial owner.

The OECD discussion drafts have also been criticized for undermining the traditional definition of beneficial owner, introducing an economic substance approach, and elevating the interpretation of beneficial owner to an antiavoidance rule.⁶⁹

In conclusion, the meaning of “beneficial owner” is evolving and therefore there is still a need for greater clarity given its growing importance in the international tax arena.⁷⁰ Taxpayers should be aware of the latest developments and current status of the matter, remain vigilant, and review their arrangements to make sure that they would successfully withstand an increasing level of scrutiny from tax authorities around the world. ◆

⁶⁹See, e.g., Jack Bernstein, “Thoughts on the OECD Discussion Paper on Beneficial Ownership,” *Tax Notes Int'l*, July 4, 2011, p. 49; and Steven Baum and Gwendolyn Watson, “Beneficial ownership as a Treaty Anti-Avoidance Tool?” *Can. Tax J.* (2012), pp. 149-168. It has been observed that as a result of the inclusion in substance tests, beneficial ownership may become a more significant part of a revenue authority’s antiabuse arsenal, since an analysis of the economic position and general relationship of the parties considering all the facts and circumstances is a much broader substance-over-form test, usually found in GAARs.

⁷⁰See du Toit, *supra* note 67, at 170 (concluding in the analysis of the beneficial ownership notion that apart from consensus that agents and nominees are not considered beneficial owners, there is great variation in legal theory, from an economic approach to a purely legal approach). See also Bundgaard and Winther-Sørensen, *supra* note 66, at 598 (“the OECD commentary to the model treaty contains only relatively vague guidelines for interpreting the term ‘beneficial owner.’ Only scarce international practice exists on the meaning of the notion of beneficial owner, and international theory cannot present a clear definition either” so that several courts do not abstain from interpreting it with reference to domestic law).