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PRACTITIONERS' CORNER

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In this article, the author discusses Ruling No. 10792 by the Italian Supreme Court and how it interacts with other guidance and authorities on beneficial ownership in Italy.

The Italian Supreme Court has held that the 5 percent reduced dividend withholding tax in the Italy-U.K. income tax treaty does not apply if the company that receives the dividend fails to prove that it is the beneficial owner under treaty article 10, paragraph 2, meaning that it received the dividend for its own economic benefit and had full right to ownership and control of it.

In Ruling No. 10792, the Court said the treaty's beneficial ownership provision is a general, anti-treaty-shopping clause that must be given a substantive, not a formalistic, meaning and requires proof that the recipient has legal and economic power and control over the income, which it receives for its own economic benefit. The taxpayer lacked that proof; thus, the Court held that the dividend was subject to Italy's full 27 percent withholding tax rate.

In the case, an Italian company distributed dividends to a U.K. holding company that was part of a group owned or controlled by a U.S. corporation. At the time of distribution, the Italian company applied Italy's 27 percent withholding tax. The U.K. company requested a refund of the difference between the 27 percent statutory rate and the 5 percent treaty rate.

In support of its refund request, the taxpayer submitted a certificate of tax residency issued by the U.K. tax authorities and documentation proving that the recipient U.K. company reported the dividends as its own income on its U.K. tax return.

The Tax Court ruled in favor of the taxpayer, and the Regional Tax Court affirmed. The appellate court adopted a formalistic interpretation of the term "beneficial owner," which it said means the person the payment is attributed to under the tax laws of its country of residence and who reports the payment on its tax return in that country.

In its petition to the Supreme Court, the Italian tax agency argued that the U.K. holding company lacked both economic substance and any meaningful organizational structure. It said the U.K. entity operated solely as a passive holding company to collect the dividends from the group's affiliated companies and distribute them along the chain of ownership, did not report any income other than financial dividends and gains, and reported a minimal amount of general and administrative expenses, proving that it had no real business operation supported by any meaningful organizational structure with staff and offices.

The Supreme Court reversed the lower decisions and found in favor of the tax agency, holding that the U.K. company had failed to prove that it satisfied the beneficial ownership requirement for the application of benefits under the Italy-U.K. treaty.

According to the Court, the beneficial ownership provision is a general antiabuse principle of international tax law meant to curb treaty shopping by taxpayers that would otherwise be ineligible for treaty benefits and subject to higher tax.

As a consequence, the beneficial ownership provisions of tax treaties must be interpreted according to their function as general antiabuse clauses and must be given a substantive meaning going beyond the tax residency requirement, the Court said. The provision ultimately requires that the income recipient receives a direct economic benefit from, and has full dominion and control over, the income subject to withholding tax, it added.

The Court reiterated that the term ''beneficial ownership'' cannot be interpreted formalistically, as it was by the appellate court, because if it were, it would overlap with the tax residency requirement and would no longer serve its specific and separate purpose of stopping treaty abuse.

OECD Guidance on 'Beneficial Owner'

The decision appears consistent with OECD guidance on the topic and provides additional certainty in a complex area of international tax law.

The 1977 commentary to the OECD model treaty provided little guidance, stating that limits on taxation in the source country are unavailable if an intermediary is interposed between the beneficiary and payer, unless the income's beneficial owner is a resident of the other contracting state.[1]

Revised commentary released in 1992 referenced reports on tax treaties and the use of base or conduit companies issued by the OECD Committee on Fiscal Affairs in November 1986. Those reports said beneficial ownership 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).

That comment was finally incorporated in the 2003 commentary to the OECD model treaty.

In its April 2011 discussion draft to clarify the meaning of beneficial owner in the model, the OECD defined the term by way of a proposed amendment to paragraph 12.4 of the commentary to article 10 to state that the dividend recipient is its beneficial owner if ''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.'' In its revised proposals regarding the meaning of beneficial owner in model articles 10, 11, and 12, the OECD offered another proposed amendment to paragraph 12.4 of the commentary to article 10. Under that revision, the dividend recipient is not the beneficial owner because its right to use and enjoy the dividend is constrained by a contractual or legal obligation to pass the payment on to another person. If the recipient has the right to use and enjoy the dividend unconstrained by that obligation, it is the beneficial owner.

New paragraph 12.4 of the 2014 update to the OECD model tax convention defines the term ''beneficial owner'' as a dividend recipient that has the right to use and enjoy the dividend unconstrained by a contractual or legal obligation to pass the payment on to another person.

EU Statutory Definition

Italy has implemented EU Directive 2003/49/EC to exempt interest and royalties paid by an EU subsidiary to its EU parent. According to the EU interest and royalty directive:

> 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.

Italian Circular 47/E of November 2, 2005, provides guidance for the interpretation and application of the directive. It states that to be considered the beneficial owner of a payment under the directive, a company must receive the payment as the ultimate beneficiary, not as an intermediary. Similarly, EU Directive 2003/48/EC, which Italy has also implemented, defines beneficial owner as any individual receiving a payment for his own benefit and as final beneficiary of the income, and Circular 55/E confirms that definition.

Italian Tax Rulings

Resolution No. 167/E of April 21, 2008, stated that a Luxembourg investment fund that received income from an Italian company could not be considered the beneficial owner of the income under the Italy-Luxembourg tax treaty if ''it operates as a mere vehicle through which the income flows to the ultimate participants to the fund.'' According to the resolution, a beneficial owner is the person resident in the other contracting state to which the income is attributed for the potential application of the tax with the consequence that an exempt fund is to be considered the beneficial owner of the Italian-source income if it is considered potentially liable for corporate income tax even if it is not subject to tax under its country's tax laws.

In July 2006 the Italian tax administration issued Resolution No. 86 on 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 owners of various patents — 26 companies organized in foreign countries — necessary for access to

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[1]Under Italian law, an agent, nominee, or intermediary is a person who acts on behalf of and for the account of the principal. The transactions or arrangements it enters into are legally binding on and affect the principal.

an international technology standard used primarily for the compression of video data, entered into an agreement to license to customers all the patents required for the use of the technology standard. To facilitate that licensing, 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,'' as well as the right to sublicense those patents to third parties.

For the use of the patents and the sale of products to customers, the U.S. corporation would pay a royalty to the patent owners based on the type and quantity of products sold and number of patent owners. The patent sublicense to third-party licensees was to be made based on standard contractual terms predetermined by the patent owners. The U.S. corporation, as administrator of the sublicensing contracts, collected the royalties from the third-party sublicensees and passed them on to the patent owners in exchange for a fee — determined as a percentage of the royalties.

The U.S. corporation acted only as an intermediary for the sublicense of the patents to third parties. It was not subject to U.S. tax on the royalties it collected on behalf of the patent owners that were taxable to the owners directly.

The Italian tax administration found that the U.S. corporation acted merely as an agent of the patent owner in licensing the patents to customers and collecting resulting royalties without any control or power over the disposition over the income. It therefore held that the Italy-U.S. treaty did not apply. It referred to article 12 of the Italy-U.S. treaty and the 1977 commentary to article 12 of the OECD model — setting out the international fiscal meaning of the term ''beneficial owner'' — as authority for that conclusion. It said the patent owners were the beneficial owners of the royalties, and that therefore, any tax treaties between Italy and the patent owners' country of residence would apply.

In Resolution No. 104 of May 6, 1996, Italian tax authorities addressed refund requests for Italian withholding tax on dividends paid to banks and other financial intermediaries acting on behalf of nonresident investors. They held that the beneficial owners of the dividends, under tax treaties with the United Kingdom, the Netherlands, and France, were those treated as the owners of the dividends and taxed on the dividends in their state of residence.

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 owned stock on behalf of U.S. pension funds, because the bank was an intermediary or agent of the pension funds for collecting the stock dividends, and the pension funds were the ultimate recipient and beneficial owners of the dividends under treaty article 10(2).

Italian Case Law

Ruling No. 10792 also seems consistent with Italian case law.

On May 4, 2012, the Regional Tax Commission of Turin issued an important decision on the burden of proof and evidence required to establish beneficial ownership of income and access treaty benefits. In the case, the Italian Tax Commission had 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, including a reduced 5 percent withholding tax rate.

An Italian company entered into a sublicensing agreement with a German company for the use of various IP, including patents, trade secrets, copyrights, know-how, and confidential information of a U.S. parent company.

Under the sublicense agreement, the Italian company paid royalties to the German company and withheld taxes from royalty payments at the reduced 5 percent treaty rate. Before entering into the sublicense agreement, the Italian company entered into a license agreement with the U.S. parent company for the same purposes and under the same conditions. Under that agreement, the Italian company 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. It therefore denied the German company the benefit of the 5 percent withholding tax rate provided by the Germany-Italy treaty.

In decision No. 124/09/2010, the Tax Commission of Turin held:

> The recipient of the payment of royalties can be considered the beneficial owner for the mere fact of being the formal recipient of the payment, whenever it may be an intermediary through which an interposition is created between the actual beneficiary of the income. For that purpose it seems relevant to determine whether the company that receives the royalties . . . has complete control also through its own organization over the activities from which the income is derived and has undertaken the entrepreneurial risks of such activities or rather it performs merely a function of collecting agent of income that is destined to other persons.

In Ruling No. 28/12/2012, the Italian Regional Tax Commission relied on a certificate issued by the German tax authorities and produced by the taxpayer stating that the German company was tax resident in Germany, had accounted for the royalties as revenue in its financial accounting, had reported the royalties as taxable income on its German tax returns, and could therefore be regarded as the beneficial owner of the royalties paid by the Italian company. As a result, the Italian Tax Commission upheld the tax court's first ruling (No. 78/09/2010) and rejected the tax authorities' assessment of additional withholding tax on the Italian payer of the income.

In Decision No. 15/6/2012, the Turin Regional Tax Commission ruled that the tax administration, which disputed that the income recipient was the beneficial owner of that income for tax treaty purposes, had the burden of proving that the recipient was simply the formal holder of the right to the payment without an organizational structure and operated as a mere intermediary without a direct economic interest in the income.

The decision is important in holding that the burden of proving the recipient is not the beneficial owner of income falls on the tax authorities. In overruling the lower court, the court of appeals held that the tax authorities cannot require further proof of beneficial ownership when the claimant has demonstrated that the recipient meets the requirements 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.

The claimant was an Italian company that licensed a trademark owned by its parent, a Luxembourg wholly owned subsidiary of a Bermuda resident company. In 2004 the Italian company applied the reduced 10 percent withholding rate on royalty payments to the Luxembourg company under article 12 of the Italy-Luxembourg tax treaty, rather than the 30 percent rate under Italy's domestic rules. The Italian tax authorities claimed that the Luxembourg company was not the beneficial owner of the income but instead a mere conduit collecting the income for the benefit of its ultimate Bermuda parent. It therefore did not qualify for the benefit of the reduced treaty rate and should pay Italy's 30 percent rate, they said.

The taxpayer argued that the Luxembourg company was the beneficial owner of the royalty payments because:

- it was the owner of the trademark, which was accounted for on its annual balance sheet;
- the income generated by the license agreement was properly accounted for in its own 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 found for the tax authorities, saying the taxpayer's argument proved only that the Luxembourg company was the formal owner of the trademark and received the royalty payments, not that it was actually the beneficial owner of the payments. In rejecting the taxpayer's position, the court said 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 the Luxembourg company had acquired the trademark for free, had no costs associated with the trademark, and maintained a limited operational structure.

The appellate court 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. It said the tax authorities had relied exclusively on arguments focusing on the composition of the Luxembourg company's shareholder (the Bermuda company), that there was neither evidence nor a reasonable presumption that the Luxembourg company was a pure conduit, and that the taxpayer's evidence had not been properly considered.

The court said the evidence showed that the Luxembourg company 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 found that the taxpayer had provided evidence that the Luxembourg company:

- incurred significant costs in purchasing the trademarks, so 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.

The court concluded that the claimant had provided sufficient evidence that the Luxembourg company met the requirements of the interest and royalties directive and was entitled to applicable treaty benefits.

Conclusion

Based on the guidance and authorities reviewed, it appears that the meaning of the term ''beneficial owner'' requires that the recipient of the income derives a direct economic benefit from it and has the full right to possess, enjoy, and dispose of it without legal or contractual obligations to pass it on to another person. ◆