

**TAX TREATIES, BENEFICIAL OWNERSHIP OF INCOME
AND DOMESTIC ANTI ABUSE MEASURES**

ITALY'S PERSPECTIVE

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TABLE OF CONTENTS

- I. Introduction – 2**
- II. Beneficial Ownership and Tax Treaties – 5**
 - A. Italian Tax Treaties (In Force) – 5**
 - B. OECD Model Convention and Commentary – 11**
 - C. International Case Law on Concept of Beneficial Ownership and Tax Treaties – 15**
 - D. Italian Tax Rulings on Beneficial Ownership and Tax Treaties - 19**
- III. Beneficial Ownership and EU Interest-Royalties Directive - 20**
- IV. Beneficial Ownership and EU Income Savings Directive - 24**
- V. Beneficial Ownership and Italian Portfolio Income Exemption - 25**
- VI. EU Parent-Subsidiary Directive - 26**
- VII. Domestic Anti Avoidance Rules - 26**
- VIII. Conclusion - 31**

I. Introduction.

Under Italian law, the concept of beneficial owner of income applies in four areas: tax treaties, EU interest-royalties directive, EU savings tax directive and 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 apply only if the recipient of the income, or the person claiming the treaty benefits, in addition of being a resident of the other contracting state, is also the beneficial owner of the income concerned.

The EU directive on interest and royalties¹ exempts interest and royalty payments between associated companies of EU member states (or their permanent establishments located in a EU member state)

¹ Council 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 n. 143 of May 30, 2005.

from tax in the state in which the payment arises. The exemption applies provided that the company (or its permanent establishment) claiming the benefit is the beneficial owner of the payment.

The EU directive on taxation of savings income² provides for a system of exchange of information between EU member states, which makes sure that an individual resident in a member state is taxed in his or her state of residence on savings income in 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, Italian domestic tax law exempts nonresidents from taxation in Italy on certain items of Italian-source portfolio income. The exemption applies to foreign persons who are resident of certain approved countries (those which allow exchange of information with Italy and included in a special list), provided that 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 Convention contain a definition of the term “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 (i.e., source country), as provided for under the typical tax treaty article 3, paragraph 2.

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

The EU interest and royalties directive provides a definition of the term “beneficial owner”, as it applies for the purposes of exempting interest and royalties paid between EU associated companies. Italian implementing legislation has transposed that definition under Italian internal law. Italian tax authorities have provided guidance on the interpretation and application of the term for the purposes of the directive by way of Ministerial Circular n. 47/E of 2006.

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

Therefore, the definition of the term “beneficial owner” contained in the EU interest and royalty directive is likely to play an important role for the interpretation of the same term used and applied for purposes of tax treaties.

The EU interest savings directive and the Italian domestic provisions on portfolio income exemption for non-resident taxpayers also have their own definitions of the term beneficial owner. Therefore,

² Council Directive 2003/48/EC of June 3, 2003, implemented in Italy with Legislative Decree n. 84 of April 18, 2005.

they also can offer useful guidance for the interpretation of the term “beneficial owner” as used and applied in tax treaties.

Moreover, Italian tax authorities generally rely on the Commentary to the OECD Model Convention and international 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 Convention revised in 2003 provides important clarifications on the interpretation of the term “beneficial owner” used in tax treaties.

The OECD Commentary directly 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 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 to the treaty benefits, try to achieve them through the use of 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).

Finally, since the beneficial owner requirement is applied as an anti avoidance provision, it interacts with domestic anti-abuse statutory provisions or judicial doctrines aimed at contrasting similar abuses outside tax treaties. In view of this interaction, the way in which those anti abuse provisions are interpreted is also important and likely to be referred to for determining the exact scope and meaning of the treaty beneficial owner requirement.

In that regard, it should be noted that 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 approach according to which the tax treatment of a transaction should be dictated by its real juridical and economic substance. In pursuing that new approach, Italian courts and tax administration often referred to international tax principles and anti abuse doctrines elaborated at EU tax law level as relevant authorities.

The above approach suggests that 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 same concept has been interpreted and applied by courts in other jurisdictions, and use it as a broad anti avoidance measure.

Recent judicial decisions like the one issued by the UK Court of Appeal in the *Indofood* case are likely to offer further support for Italian tax authorities and courts who 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 is currently an increasing risk that arrangements that were considered safe may be put under attack, and tax benefits that could be taken for granted may be challenged or denied in the future.

In this article we want to provide an overview of the concept of beneficial ownership of income from the perspective of Italian international tax law, as it arises in the context of tax treaties, EU directives and domestic legislation, and of its interaction with other domestic anti-abuse provisions and judicial doctrines.

As we move along with the analysis of the relevant authorities and areas of law it will appear that the concept of beneficial ownership is emerging as a broad anti abuse 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 for tax purposes in his home jurisdiction.

It will also appear that there may be 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. Beneficial Ownership and Tax Treaties.

A. Italian Tax Treaties (In-Force).

1. In General.

Italy has seventy-seven tax treaties in force.

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

A literal reading of the typical language of the portfolio income provisions of most Italian tax treaties seems to require that the person invoking the treaty be both the recipient and beneficial owner of the income. This would mean that the ultimate beneficial owner of 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 tax treaties' fundamental purpose of preventing double taxation. To clarify this issue the text of the OECD Model Convention was amended in 1995 and paragraph 12.2 of the current Commentary to article 10 of the OECD Model Convention makes clear that treaty benefits remain available when an agent or 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 this has been the consistent position of all member states.

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

2. Italy-Germany Tax Treaty.

Italy-Germany tax treaty is the only treaty that contains a definition of the term “beneficial owner”.

The definition is set forth in paragraph 9 of the Protocol to the treaty, which reads as follows:

“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”.

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

The beneficial owner of income is the person who is entitled to the right with respect to which the payment is made, for general contract law purposes, and to whom 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.³

The Protocol to Italy-Turkey tax treaty contains a special provision on the beneficial ownership requirement of articles 10, 11 and 12, which however sheds limited light on the meaning of that term⁴.

4. Italy-Switzerland Tax Treaty.⁵

³ Signed on July 27, 1990, ratified on June 7, 1993 and entered into force on December 1, 1993.

⁴ Paragraph V of the Italy-Turkey tax treaty's 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*”.

The residence article of Italy-Switzerland tax treaty 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 which actually receives the income (also indirectly through other individuals or legal entities) does not qualify as resident under the treaty⁶.

The provision employs very broad terms and is extremely 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 making reference also to the case where the ultimate income beneficiary receives the income indirectly through other individuals or entities.

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

The portfolio income articles of Italy-Switzerland tax treaty provide for relief of 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 Convention or Commentary.

5. Italy-Australia Tax Treaty⁷.

In Italy-Australia tax treaty, relief from source-country withholding tax on portfolio income is provided with respect to 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 Italy-Australia treaty and has no equivalent in the OECD Model Convention or Commentary.

6. Italy-U.S. Tax Treaty⁸.

⁵ Signed on March 9, 1976, ratified on December 23, 1978 and entered into force on March 27, 1979.

⁶ See article 4, paragraph 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*".

⁷ Signed on December 14, 1982; ratified with law n. 292 of May 27, 1985 and entered into force on November 5, 1985.

⁸ Signed in Rome on November 16, 1985; ratified with law n. 763 of December 11, 1985 and entered into force on December 30, 1985.

The Joint Committee on Taxation Explanation (JCS-30-85, July 29, 1985) on the interest article of US-Italy tax treaty states the following:

“the lower rate in the proposed treaty applies only if the interest is beneficially owned by a resident of the other country. Accordingly, it does not apply if the recipient is a nominee for a nonresident”.

The same comment is made with respect to the royalty article of the treaty.

Identical language is contained in the Senate Foreign Relations Committee Report (S. Exec. Rpt. 99-6, Dec. 11, 1985).

Articles 10-11-12 of the pending U.S.-Italy treaty are identical to the corresponding articles of the 1985 in-force treaty.

The U.S. Treasury Department Technical Explanation to pending U.S.-Italy treaty (October 27, 1999)⁹, whose articles 10-12 are unchanged from the current treaty, states as follows (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)”.

Similar comments are made in the U.S. Treasury Technical Explanation with respect to articles 11 (interest) and 12 (royalties).

Article 10, paragraphs 10, article 11, paragraph 9 article 12, paragraph 8 of the US-Italy pending treaty contain a general anti abuse 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 in respect of which income is paid is to take advantage of the treaty.

7. Tax Treaties Not Containing the Beneficial Owner Requirement.

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

⁹ Signed on August 25, 1999.

They include treaties with Cyprus (1974), Hungary (1977), Ireland (1971), Japan (1969 and amended in 1980), Morocco (1972), Tanzania (1973), Thailand (1977), Trinidad & Tobago (1971), Yugoslavia (1982), which applies to Bosnia 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 with respect to dividends, interest or royalties “paid to” a resident of the other contracting state.

8. Tax Treaties Containing Anti-Abuse (Main Purposes) Clauses.

Italian tax treaties with Estonia¹⁰ and Lithuania¹¹ (EU member states) contain general anti-abuse (limitation of benefits) provisions according to which a resident of the contracting state shall 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 such resident or of any person connected with such resident was to obtain the benefits of the treaty that would not otherwise be available¹².

Those treaties also contain a saving 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 arising from transactions between enterprises of a contracting state and enterprises situated in the other contracting state, if the main purposes or one of the main purposes of the creation of such enterprises or of the transactions undertaken between them, was to obtain the benefits of the treaty that would not otherwise be available¹³.

The reference is to Italy’s anti-abuse provisions on limitation of deductions set forth in Tax Code article 110, paragraph 10. They apply to transactions entered into with enterprises located in low tax foreign jurisdictions included in a specific list (black list) although 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 trade or business in its state of residence, or the transaction is a bona fide business transaction and has been actually carried out¹⁴.

As a result of the treaty clause, Italy can continue to apply its domestic anti abuse provisions referred to above to transactions entered into between an Italian enterprise and a treaty partner (without incurring in treaty override or a violation of the treaty’s non discrimination provisions),

¹⁰ Signed on March 3, 1997, ratified with law n. 427 of October 19, 1999 and entered into force on February 22, 2000.

¹¹ Signed on April 4, 1996, ratified with law n. 31 of February 9, 1999 and entered into force on June 6, 1999.

¹² Article 28, paragraph 1 of Italy Estonia treaty and article 30, paragraph 1 of Italy-Lithuania treaty.

¹³ Article 28, paragraph 2 of Italy-Estonia treaty and article 30, paragraph 2 of Italy-Lithuania treaty.

¹⁴ For an overview of Italy’s anti abuse rules limiting deduction of costs incurred in transactions with foreign enterprises organized in black listed jurisdictions, see Marco Rossi, “Italy Clarifies Scope of Anti Abuse Rules”, in *Tax Notes Int’l*, July 3, 2006, p. 7.

provided that 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.

Pending U.S.-Italy 1999 treaty contains anti-abuse provisions in its portfolio income articles.

They are more limited in scope than a general anti-abuse 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 Application of Treaty Benefits.

Italian payers are authorized not to apply the withholding tax (in case of treaty exemption) or to charge directly the treaty's lower withholding tax (in case of treaty reduction of withholding tax)¹⁵.

For this purposes they have to collect the following documentation:

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

A false statement constitutes fraud and is punished as a crime.

10. Interpretation of the Term "Beneficial Owner" in the Absence of Treaty Definition.

In the absence of a definition of the term 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 purposes (typically under article 3, paragraph 2 of the treaty).

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

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 Convention, taking into account also the way in which it is interpreted and applied in other jurisdictions¹⁶.

¹⁵ See resolution n. 95/E issued on June 10, 1999 and resolution n. 68 issued on May 24, 2000.

¹⁶ This position has been taken in the recent ruling n. 84/E of July 12, 2006, which is discussed in more detail at paragraph D.1, below.

Italian tax administration¹⁷ and courts¹⁸ have been consistent in maintaining the view that the OECD Model Convention 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.

Later versions of the Commentary, however, are also relevant, in general and especially if they are used to clarify the meaning of certain treaty provisions that have not been changed in the meantime.

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

Finally, considering the anti abuse function assigned to the “beneficial ownership” requirement in the treaty context, it may be reasonably argued that such term should be interpreted consistently with the meaning of domestic anti avoidance rules.

We discuss below all those possible sources of authority for the interpretation of the term “beneficial owner” that are relevant under Italian law.

B. OECD Model Convention and Commentary.

1. The 1977 Commentary.

The “beneficial ownership” requirement was used for the first time in the 1977 OECD Model Convention.

The OECD Model Convention did not define the term “beneficial ownership”.

The Commentary to the 1977 Model Convention provided only limited guidance on the meaning of the term beneficial owner.

¹⁷ See circular no. 207/E of November 16, 2002 (referring to the Commentary to article 3 of the OECD Model Convention for the definition of the term “person” for the purposes of the application of domestic CFC rules); resolution n. 145/E of September 10, 1999 (referring to the Commentary to article 17 of the OECD Model Convention concerning taxation of income of artists and sportsmen).

¹⁸ See Corte di Cassazione, judgment no. 11648 of 5 September 2000 (the Supreme Court referred to the Commentary to article 7, paragraph 3 of the OECD Model Convention to decide a case concerning the allocation of costs between head office and its permanent establishments); Corte di Cassazione, judgments nos. 3367 and 3369 of March 7, 2002 and 7689 of May 25, 2002 (the Supreme Court referred to the Commentary to article 5 of the OECD Model Convention to decide a series of cases concerning the existence of a permanent establishment in Italy of a foreign company), and Corte di Cassazione, judgment no. 7851 of April 23, 2004 (the Supreme Court referred to the Commentary to article 7, paragraph 2 to decide whether VAT is due on transfers between the head office and its permanent establishment).

It stated that the limitation of tax in the state of source was not available when an intermediary, such as an agent or nominee, was interposed between the beneficiary and the payer, unless the beneficial owner of the income is a resident of the other contracting state¹⁹.

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

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

The agent is the legal owner of the assets or the income arising from the transaction for general law purposes. In case of bankruptcy, the agent's creditors can enforce their claims upon the assets or income acquired in the transaction, which are treated as agent's personal assets and income for this purpose.

Therefore, following the Commentary's explanation, considered in the context of Italian law, the principal as opposed to the agent would be regarded as the beneficial owner only in situations in which a person acted as agent on behalf of (i.e., with legal effects arising directly upon) and with authority to bind the principal.

This is the "narrow technical meaning" of the term beneficial owner under Italian law following the above approach. Anybody who contracts or acts on his own behalf and acquires or holds the bear legal title to the property, is treated as the beneficial owner of the income arising from that property.

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

On the other hand, the Commentary to article 1 of the OECD Model enlarged the picture and expressly referred the concept of beneficial ownerships to treaty abuse.

It observed that taxpayers might try to obtain tax relief under tax treaties through the use of artificial legal constructions, as it would be the case if a person acted through a legal entity created in a contracting state essentially to obtain treaty benefits that would not be available directly to such person.

¹⁹ See paragraph 12 of the Commentary to article 10, paragraph 8 of the Commentary to article 11, and paragraph 4 of the Commentary to article 12.

It also pointed out that some of these situation are dealt with in the Convention, e.g. 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-treaty abuse provision in light of the treaty’s object and purposes.

The subsequent revisions of the Commentary are a confirmation of this approach.

2. The 1992 Commentary to the OECD Model Convention and OECD 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 of 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 as follows with respect to the meaning of the “beneficial ownership” provision for limitation of 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)”.

This comment was finally included in the 2003 Commentary to the OECD Model Convention (see paragraph 3 below).

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

It draws a distinction between the holder of bear legal title to the income, having 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 in question 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, which emphasizes substance over form and focuses on the economic substance and business purpose of the transaction for determining the person who is eligible for treaty benefits.

3. The 2003 Commentary to OECD Model Convention.

The revised Commentary to the 2003 OECD Model Convention (“2003 Commentary”) added further comments on the interpretation of the beneficial owner concept on the basis of the above clarifications.

3.1. 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 avoidance²⁰”.

The above comments 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 as a more far reaching anti-treaty abuse clause.

3.2. The Agent, Nominee or Intermediary Case.

With reference to the agent or intermediary case, the Commentary stated as follows:

“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”²¹.

According to that clarification, under the beneficial owner requirement treaty benefits are denied when the immediate recipient of the income acts in the capacity of agent or nominee, and consequently is not treated as the owner of the income and is not taxed on the income in 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 or not, under the rules of the recipient’s residence country,

²⁰ Paragraph 12 of the Commentary to article 10, paragraph 9 to the Commentary to article 11, and paragraph 4 to the Commentary to article 12.

²¹ Paragraph 12.1 (second and third sentence) of the Commentary to article 10; paragraph 10 of the Commentary to article 11, and paragraph 4.1 of the Commentary to article 12.

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, then the recipient should not qualify as beneficial owner and should not be eligible for the benefits of the treaty.

As a matter of Italian law, this 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 arising 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, such person would be regarded as the owner of the income and would be taxable upon that income, and therefore he should qualify as beneficial owner and be entitled to treaty benefits under that narrow technical meaning.

3.3. The Conduit Case.

With reference to the conduit case, the Commentary stated as follows:

“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”²².

Contrary to the agent, intermediary or nominee test, which is a legal test aimed at determining whether a person is the owner of the income for tax purposes and subject to tax on that income in his home country, the conduit test is a facts and circumstances test aimed at determining whether a person is the real owner of the income in an economic sense, receiving the income for his own benefit, as opposed to the holder of a bare legal title to the income with no independent powers of enjoyment and disposition of the income and acting for account of the real owner and beneficiary of the income concerned.

The inquiry has to be conducted on the basis of all the facts and circumstances of the transaction.

The test asks to establish whether, under the laws of the recipient’s state of residence, the recipient, even though it may be treated as the legal owner of the income for tax purposes and is taxed in respect of that income, possesses or retains so narrow or limited powers on the income

²² See Commentary to article 10, paragraph 12.1 (fourth and fifth sentence) to the OECD Model Convention.

as a result of restrictions or limitations provided for by law or under the terms of his contractual relationship with the final beneficiary of the income, that in fact he lacks an independent power to realize and dispose of the income based on his own judgment and for his own direct benefit, and ultimately acts in the same way as a fiduciary or administrator for account and in the interest of another person who is the final income beneficiary in relation to the income concerned.

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

The UK Court of Appeal relied upon the Commentary above in referring to the “international fiscal meaning” of the term beneficial ownership that it applied in the *Indofood* decision.

C. International Case Law on Concept of Beneficial Ownership and Tax Treaties.

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 the Republic of Honduras, and between the Honduran corporation and its indirect parent.

No withholding tax was due upon the interest paid by the U.S. corporation to the Honduran corporation under the U.S.-Honduras treaty, and no withholding tax was charged upon 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 per-cent withholding tax would have applied (under US law).

The 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 (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 such payments from the ultimate borrower. Although the US-Honduran treaty exempted interest received by a treaty partner resident (and the Honduran corporation was respected and not treated as a sham), the court interpreted “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 Circuit, March 13 and 25, 1996), a U.S. corporation organized a finance subsidiary in Curacao, the Netherlands Antilles (to which the U.S.-Netherlands Antilles applied) for the purpose of issuing notes in the Eurobond market. The finance subsidiary borrowed \$70 million at 17 ¼ per cent interest rate in that market and lent that amount to its U.S. parent at 18 ¼ per cent interest rate.

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

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

The lesson from *Aiken Industries* and *Northern Indiana* was that the financial intermediary, at a minimum, has to earn a profit (to 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 prior to the enactment of the portfolio interest exemption in 1984 is ample testimony.

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

3. Indofood.

In *Indofood International Finance Limited v. JP Morgan Chase NA London Branch* (2006), Indofood, an Indonesian multinational company, wished to raise finance through the issue of internationally marketed loan notes. It did so through a finance subsidiary organized in the Mauritius.

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

Under the terms of the loan note issue, if the withholding tax on the notes increased above 10 per cent and no “reasonable measure” could be found to avoid it, the Indonesian company (which would pay for increase) would be entitled to redeem the notes. JP Morgan Chase represented the note-holders as trustee, and the loan note issue referred any disputes under the loan issue to UK courts.

Indonesia decided to terminate the treaty with Mauritius.

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

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

The Indonesian company refused that solution and the dispute was referred to the UK courts.

One of the issues that the UK Court of Appeal had to decide was whether the Dutch subsidiary would be treated as “beneficial owner” of the interest payments received from the note-holders and would be eligible for the exemption from withholding tax under the Netherlands-Indonesia 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 interest received (other than to fund its liability under the loan with the parent), and was even obliged to use the interest received from note-holders to pay the interest due to the parent. The two loan agreements also had very tight payment dates.

The court referred to the “international fiscal meaning” of the term beneficial ownership, as it appears from the Commentary to the OECD Model Convention, which requires power of disposing of income to be received for recipient’s direct benefit, as opposed to what it called a “narrow technical” domestic law meaning of that term, and held that under that international tax standard the Dutch subsidiary did not qualify as beneficial owner of the income and would be subject to full withholding tax.

4. International Reactions to Indofood.

Diane Hay, UK Deputy Director of Revenue Policy – International, speaking on March 17, 2006 at Georgetown-ABA Conference:

“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, US Treasury Deputy International Tax Counsel:

Beneficial ownership *“is being used now against taxpayers in a variety of circumstances to deny treaty benefits in case 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 that 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, Canada's Department of Finance Director of Tax Legislation:

"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".

2006 Indonesian Ruling on beneficial ownership: Indonesian Tax Authority's Ruling Letter S-95/PJ.342/2006 states that the factors to be considered in conforming beneficial ownership of income for treaty purposes include:

- whether all the income received from the source country is subject to tax in the resident or domiciled country 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 operation;

or

- whether the foreign company's shares are listed on a recognized stock exchange.

There is evidence that tax authorities in other countries may be going to review existing financing structures under the beneficial ownership requirement²³.

D. Italian Tax Rulings on Concept of Beneficial Ownership and Tax Treaties.

1. Resolution n. 86 of July 12, 2006.

The Italian tax administration on July 12, 2006 issued a ruling (resolution n. 86) concerning the notion of beneficial ownership under U.S.-Italy treaty in a back-to back royalty arrangement in which a U.S. corporation acted as 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 for the purpose of licensing the patents to customers and collecting the royalties there-from, without

²³ See Jack Bernstein and Lousie R. Summerhill, "Canada Takes Aim at Concept of Beneficial Ownership", in *Tax Notes Int'l*, August 28, 2006.

any control or power of disposition over the income, and therefore held that the U.S.-Italy treaty did not apply.

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

The owners of various patents (twenty-six companies organized in foreign countries) necessary to get access to an international technology standard employed primarily for the compression of video data entered into an agreement (“Agreement among licensors”) according to which they agreed to license to customers all of their patents required for the use of the technology standard.

To facilitate the license of the patents to customers, they entered into an agreement with a U.S. corporation (“License from licensor to licensing administrator”), pursuant to which each patent owner granted to the U.S. corporation

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

In case of 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 the owners of the patents).

The sub-license of the patents to third party licensees should be made on the basis of standard contractual terms predetermined by the patent owners. The U.S. corporation as administrator of the sub licensing contracts, collect the royalties from the third party sub licensees and pass them on to the patent owners, in exchange for a fee (determined in a percentage of the royalties) for its administrative services.

The U.S. corporation acted only as intermediary for the sub-license 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 U.S.-Italy treaty and the 1977 version of the Commentary to article 12 of the OECD Model Convention (setting out the international fiscal meaning of the term “beneficial owner”) as authority for its conclusion that the U.S. corporation, having acted as intermediary or agent for the patent owners, was not entitled to the benefits of the U.S.-Ital 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.

2. Resolution n. 104 of May 6, 1996.

In resolution n. 104 of 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 inventors, stated that the beneficial owners of the dividends pursuant to tax treaties with UK, the Netherlands and France are those who are treated as the owners of the dividends and are taxed on the dividends in their state of residence.

3. Resolution n. 431 of May 7, 1987.

In ruling 431 of 1987 the tax administration ruled that the U.S.-Italy tax treaty applies with respect to Italian source dividends paid to a UK bank that owns stock on behalf of U.S. pension funds, because the UK bank is an intermediary or agent of the pension 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, paragraph 2 of the U.S.-Italy tax treaty.

III. Beneficial Ownerships and EU Interest and Royalties Directive.

1. Overview.

The 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 permanent establishments located in a EU member state) from any tax to be levied (either through withholding or by assessment) in the state of source of the payment.

For purposes of 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 a EU member state according to the tax law of that state, and are not to be considered resident outside the EU for tax purposes pursuant to 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 25 per cent stock ownership in a parent-subsidiary or brother-sister relationship.

The stock ownership requirement is met if the payer owns directly at least 25 per-cent of the stock of the payee, the payee owns directly at least 25 per-cent 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 per-cent of the stock of both the payer and the payee.

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

The exemption is granted also for interest or royalty payments made by or to permanent establishments of qualifying EU associated companies.

A permanent establishment is defined as a fixed place or 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 permanent establishment) must be the “beneficial owner” of the interest or royalty payment.

In case of 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 anti-abuse provision according to which the member states are not prevented from applying their domestic provisions for the prevention of fraud or abuse and may withdraw the benefits of the directive or refuse to apply the directive in case of transactions the principal purpose or one of the principal purposes of which is tax evasion, avoidance or abuse.

2. 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 permanent establishment.

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”.

The test refers to the agent or intermediary situation and would seem to focus on whether the corporate recipient acts for its own behalf, acquiring the legal title to the right or asset and the relating income, or as 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 Convention, and would accord beneficial ownership status to the recipient unless this acts in a strict agent/principal relationship on behalf of another person.

However, the expression “its own benefit” might implicate a more substance-over-form analysis directed at investigating whether the company, in addition of being the legal owner of the income, has also 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 concerned.

The directive’s definition of beneficial owner for permanent establishments recipient is the following:

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

- (a) 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*
- (b) 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)”.*

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

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

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

3. Italy’s Implementing Legislation.

Italy implemented the directive by way of Legislative Decree n. 143 of May 30, 2005 (with retroactive effect to interest or royalties accrued as from January 1, 2004).

In implementing the directive, Italy provided that the company or the permanent establishment 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 permanent establishment 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 permanent establishments. By imposing the subject to tax requirement also for payments made to companies, Italian domestic legislation strengthened the beneficial ownership requirement as it applies to companies.

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

Pursuant to the revised anti avoidance 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.

4. Italy's Administrative Guidance on the Interest and Royalties Directive.

Italy's tax administration has provided guidance on the interpretation and application of the interest and royalties exemption by way of Ministerial Circular n. 47/E of November 2, 2005.

The Circular states that the specific subject-to-tax requirement prescribed also 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 insure 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 beneficial owner of a payment, a company must receive the payment as the ultimate beneficiary, and 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 derives a direct "personal economic benefit" from the income arising 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 anti-abuse purpose of the beneficial ownership clause, a company shall be treated as beneficial owner of the income if it has the "power of realization and disposition" of the income concerned.

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

With respect to interest and royalties received by permanent establishments, the Circular confirms that beneficial ownership requires that the right or property generating the income be effectively connected to the permanent establishment, that is, be held and used by the permanent establishment in the conduct of its trade or business, and that income paid with respect to that right or property be included in the permanent establishment's taxable income subject to tax in the state where the permanent establishment is located.

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

IV. Beneficial Ownerships and EU Interest Savings Directive.

EU Directive 2003/48/EC of June 2, 2003 (to be implemented by member states within January 1, 2004) provides for an automatic exchange of information system to make sure that saving income in 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 n. 84 of April 18, 2005.

Under that system, a paying agent (bank, financial institution) established in a EU member state who 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 certain 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 who are exonerated from the exchange of information charge a back-up 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 a EU member state.

For this purpose "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. Beneficial Ownership and Italian Portfolio Income Exemption.

Italian law exempts non residents from the gross-basis 12.5% tax on interest paid with respect to 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 sale of portfolio stock in Italian companies, income from derivative transactions, 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 who are resident in foreign countries that maintain an exchange of information system with Italy and are included in a special list (so called "white

list”), provided that the nonresident person who claims the exemption is the beneficial owner of the income.

Ministerial Circular n. 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 income final beneficiary.

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

For the purposes of the exemption, foreign funds, even if transparent under foreign law, are treated as residents in their own 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 the purpose of managing investments of a limited number of investors, even though their statutory purpose is managing investments, and to trusts and partnerships that have been formed for the purposes of enabling their investors (who would not qualify for the exemption) to benefit from the exemption, which otherwise would not apply.

To benefit from the exemption, the nonresident investor must provide the debtor or the payer with a certificate of tax residency issued by the tax administration of his country of residence and an auto certification statement attesting that he is the beneficial owner of the income and satisfies all other requirements for the exemption, providing also 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 a EU subsidiary company to its EU parent) does not contain a beneficial ownership requirement.

Italy included in its domestic implementing legislation an anti-abuse 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. Domestic Anti Avoidance Rules.

1. General Anti Abuse Doctrine.

In *Halifax*²⁴, the taxpayer (a UK 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 on construction services by its suppliers (that it would have not been able to claim, had it carried out the transaction directly).

The European Court of Justice ruled that the input VAT credit was not available to the taxpayer, because the “*essential aim*” of the transaction was to obtain a tax advantage. It also stated that EU law (in the case, the right 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 anti-abuse doctrine that can be used for interpreting and applying domestic tax laws intended to prevent tax avoidance, and relied upon 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 (decided with ruling n. 20398 issued on 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 were distributed, at a price equal to the value of the stock plus the amount of dividend.

The purchaser collected the dividend and immediately thereafter (pursuant to a prearranged plan) it 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 purchaser for an amount 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 profits or losses for the parties.

²⁴ *Halifax PLC. at al v. Commissioners of Customs and Excise (C-255/02)*, February 21, 2006.

Tax law in effect at the time of the facts did not contain any anti-avoidance provisions that could challenge this type of transaction²⁵.

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

According to the Court, the abuse of law doctrine compelled the Court to find legal remedies within domestic law to disregard transactions aimed only at 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.

Pursuant to 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 for the purpose of collecting the dividend payment. The dividend income and capital loss realized by the purchaser of the stock were ignored and the dividend was subjected to withholding tax as if it had been actually paid to the fund.

The second case (decided with ruling no. 22932 of November 14, 2005) presents facts similar to those of the previous one, except that 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 (that was treated as purchase price of the stock).

Pursuant to the abuse of law doctrine and domestic civil law provisions that disregard transactions lacking valid consideration and carried out in fraud of law, the Court disregarded the transaction as abusive and held that the dividend was subject to withholding tax as if it had been paid directly to the foreign person.

With order n. 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” test²⁶, in the context of a similar case involving abuse of input VAT credit.

2. Statutory Anti-Avoidance Provisions.

²⁵ Article 37-bis of Presidential Decree no. 600 of September 29, 1973 (which most likely would have struck down that transaction) has been enacted later.

²⁶ For a discussion of Italian Supreme Court’s order n. 21371 and its implications under Italian tax law, see Marco Rossi, “Italian Supreme Court Wants Clarity on *Halifax* Test”, in *Tax Notes Int’l*, December 4, 2006, p. 735.

Article 37-bis of Presidential Decree n. 600 of September 29, 1973 contains the most important Italian statutory anti avoidance provisions.

They apply to specific transactions listed therein, which include corporate mergers, acquisitions, divisions (spin offs, split offs and split ups), liquidations, and equity distributions; contributions and transfer of businesses (going concerns); 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; transfer of assets by affiliated companies filing a consolidated tax return; and interest and royalties payments between associated companies eligible for exemption under the EU directive.

The provisions apply to a transaction, or a series of transactions part of a scheme, which lack economic substance and are 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 additional clarifications on the non-tax reasons of the transaction.

The assessment must be specifically motivated also in reply to any explanations provided by the taxpayer.

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

3. Statutory Anti-Conduit Rules.

Article 37 of Presidential Decree n. 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 appears to be the formal owners, if it is proved, also by way of presumptions, that the first person is the real possessor and beneficiary of the income through such other persons.

The above provision must be read in combination with the substantive provision of article 1 of the 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 the income concerned.

The tax administration has tried from time to time to use the above provisions as broad anti conduit or anti avoidance rules.

So far, the Supreme Court has taken the position that they 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 occurs when the parties enter into an official contract and at the same time they also 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 agents²⁷.

4. Substituted Income Rule.

Article 6, paragraph 2 of 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.

5. Cross-Border Anti Avoidance Provisions.

Tax avoidance provisions have been enacted recently in the context of outbound investments.

Under new anti-inversion residency provisions, a foreign nonresident entity is treated as resident in Italy for tax purposes (and 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 rule if they demonstrate that the place of effective management and control of the entity is outside Italy.

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

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

6. Domestic Anti-Avoidance Provisions and Tax Treaties.

The relationship between tax treaties and domestic anti avoidance rules and the applicability of domestic anti avoidance provisions to tax treaties are particularly complex matters. The Commentary to article 1 of the OECD Model Convention discusses them at paragraphs 7-10.

²⁷ Corte di Cassazione, judgment no. 8161 of October 21, 1994.

From the Italian perspective it must be observed 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. Consequently, they should prevail over domestic law also under the criteria according to which a specific law prevails over a general law.

Finally, the circumstance that some treaties contains general anti abuse provision (as it is the case for the Italian treaties with Estonia and Lithuania) or special anti abuse provisions (as it is the case for the Italian pending treaty with the US) offers a strong argument to sustain that, in the absence of such provisions in a given treaty, domestic anti avoidance rule should not apply.

This view is further supported by the fact that, although tax treaties are international law in nature, they also retain their character as international agreements, and a very 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 contained in the agreement itself.

At the same time, there are also valid arguments to sustain that domestic anti abuse provisions should always apply, even on matters covered by treaties.

According to the Italian Supreme Court, treaty rules are conflict 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 item of income between the contracting states. Even when a treaty applies, taxes continue to be applied pursuant to and in accordance with the domestic law of the two contracting states²⁸. Under this approach, a treaty abuse ends up being an abuse of domestic tax law, and there should be no reason why domestic anti abuse provisions should not apply just in that case.

Also, domestic rules on characterization of the transaction or determination of taxpayer who is treated as deriving the income do not conflict with tax treaties, which is applied taking 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 anti avoidance rules results in re-characterization of income or re-determination of the person who is treated as the taxpayer with respect to a particular transaction, treaties should not interfere and should be applied taking into account such changes²⁹.

²⁸ Corte di Cassazione, judgment no. 1122 of February 2, 2000.

²⁹ See Commentary to article 1 of OECD Model Convention, paragraph 22.

Even if they do not apply directly to tax treaty matters, domestic anti abuse provisions like the ones briefly mentioned above may be used as means of interpretation of express or implied anti abuse provisions contained in tax treaties.

VIII. Conclusion.

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

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

In both cases 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” provided for therein, Italy has adopted the position that beneficial ownership requires the power of disposal of the income, which the taxpayer must receive for his own benefit, and taxation of the income in the taxpayer’s residence state.

That interpretation is consistent with the definition of the term “beneficial ownership” provided in the Italy-Germany tax treaty (the only one of the seventy seven Italian tax treaties in force that contains a definition of that term).

It is also consistent with the interpretation of the term “beneficial ownership” offered by the Commentary to the OECD Model Convention.

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 the light of the object and purposes of the convention, which include the avoidance of double taxation and the prevention of tax evasion and treaty abuse.

If the immediate recipient of the income is not treated as the owner of the income and subject to tax on that income in his state of residence, or, despite being treated as the formal owner of the income and being taxed on that income in his state of residence, he passes on the income to a non treaty partner in a back-to-back transaction in which he has no power of disposition of the income and does not retain any economic benefit in relation to the receipt of that income (acting more like an administrator of 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 the light of the above, the beneficial ownership concept appears to be interpreted as a broad anti-abuse provision designed to prevent treaty and EU law shopping.

Domestic anti avoidance provisions aimed at preventing 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 of whether the taxpayer has a real power of disposition of the income and receives it for his own benefit is highly factual and depends on the circumstances of the case.

In this respect, it may be argued that the recent decision of the UK Court of Appeal in the *Indofood* case 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 limitation of benefits provision include 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 in a case in which the financial subsidiary earned a profit and satisfied substance requirements under its home country’s law.

If picked up in other jurisdictions, that decision may provide to tax authorities a golden opportunity to challenge structured finance transactions or back-to-back license arrangement that may have been considered safe so far.

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 such type of stricter scrutiny.