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1 author:

Roberto Succio

Amedeo Avogadro University of Eastern Pied…

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Roberto Succio is a tax attorney and a professor of tax law at the University of Eastern Piedmont in Alessandria, and at the University of Turin, Cuneo, in Italy.

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In Decision No. 4600 of February 26, the Italian Supreme Court (Corte di Cassazione) considered the tax treaty entitlement of a Japanese fund in relation to dividends distributed by Italian companies via a U.S. limited liability partnership. The rationale behind the Supreme Court's decision is unusual and reveals an interpretation of the relevant tax treaties that may be criticized from an OECD model convention perspective.

The case was submitted by a Japanese fund (the Fund) controlling a U.S. limited liability partnership (U.S. LLP), which in turn held participations in Italian companies. Dividends distributed by the Italian companies were subject to the domestic (at that time 32.4 percent) withholding tax, and the Fund claimed a refund of the difference between the withholding tax and the reduced 15 percent withholding tax granted by article 10 of the Italy-Japan tax treaty.

Currently, according to the domestic provisions, dividends distributed to nonresident entities are ordinarily subject to a 27 percent withholding tax (save for the possibility to claim a refund of up to four-ninths of the withholding tax if the recipient can show that it has paid a final tax on the same dividends). However, the Finance Bill of 2008 introduced a reduced 1.375 percent rate for dividends paid to entities subject to ordinary corporate tax in their home state that are resident in European Union or European Economic Area ''white-list'' states. The 1.375 percent rate applies irrespective of compliance with the conditions required under the EU parent-subsidiary directive.

The line of reasoning adopted by the Fund was as follows: Dividends distributed by the Italian companies to U.S. LLP did not benefit from the reduced withholding tax granted by the Italy-U.S. tax treaty since U.S. LLP, as a limited liability partnership, was not entitled to the application of the U.S. tax treaty. However, the Fund was qualified as the ''beneficial owner'' of the dividends according to article 10 of the Italy-Japan tax treaty. This allowed it to benefit from the application of the reduced 15 percent withholding tax.

According to article 10, paragraph 2 of the Italy-Japan tax treaty:

> dividends may be taxed in the Contracting State of which the company paying the dividends is a resident, and according to the law of that Contracting State, but the tax so charged shall not exceed: (a) 10 percent of the gross amount of the dividends if the recipient is a company which owns at least 25 percent of the voting shares of the company paying such dividends during the period of six months immediately before the end of the accounting period for which the distribution of profits takes place; (b) in all other cases, 15 percent of the gross amount of the dividends.

The tax administration rejected the refund request, and after conflicting rulings of the tax courts, the Fund appealed to the Supreme Court.

In particular, the Fund appealed against the tax court of first instance (Commissione Tributaria Provinciale) that accepted its claim. The Tax Office in turn appealed the tax court decision to the tax court of second instance (Commissione Tributaria Regionale), which accepted its petition.

Literal Interpretation

The Supreme Court rejected the Fund's request based on a literal interpretation of the Italy-Japan tax treaty.

Article 10, paragraph 2 of the treaty does not contain the normal beneficial ownership clause. According to this provision, the reduced taxation of dividends in the state of source is granted only to the beneficial owner of the dividend payments.

The Supreme Court ruled that the reduced withholding tax provided under the Italy-Japan tax treaty applies only when the actual recipient is a resident of the contracting state (in our example, Japan), irrespective of who the beneficial owner of the relevant payments is.

Here, dividends were actually distributed by the Italian companies to U.S. LLP, a U.S. partnership; consequently, the Italy-Japan tax treaty does not apply and the Fund, regardless of whether it's the beneficial owner of the distributions, was not entitled to benefit from the reduced Italian withholding tax provided under the treaty.

The decision was surprising to most tax practitioners, and it clearly will give rise to difficulties when dividends are paid to transparent entities.

The Italian tax authorities and courts have moved from a formalistic approach, which focused 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 the new approach, Italian courts and tax administration often referred to international tax principles and antiabuse doctrines elaborated at the EU tax law level as relevant authorities, and sometimes to the OECD commentary suggestions.

This time, the Supreme Court ignored every contribution of this kind in its decision.

'Beneficial Owner' in Italian Tax Law

Under Italian law, the concept of the beneficial owner of income applies in four areas:

- tax treaties;
- the EU interest and royalties directive;
- the EU savings tax directive; and
- the domestic portfolio income exemption.[1]

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

The EU directive on interest and royalties exempts interest and royalty payments between associated companies of EU member states (or their permanent establishments located in an EU member state) from tax in the state in which the payment arises. The exemption applies if the company (or its PE) claiming the benefit is the beneficial owner of the payment. The EU directive on the taxation of savings income provides for a system of information exchange between EU member states, which ensures that an individual resident in a member state is taxed in his state of residence on savings income in the form of interest earned from another member state. The directive applies if the individual receiving the income, being a resident of a member state, is also the beneficial owner of the income.

> **Italian tax law does not contain a definition of beneficial owner for general tax or treaty purposes.**

Finally, Italian domestic tax law exempts nonresidents from taxation in Italy on some items of Italian-source portfolio income. The exemption applies to foreign persons who are residents of approved countries (those that allow exchange of information with Italy and are included on a special list), provided 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 contains a definition of beneficial owner.

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[1]The Italian tax authority has faced the topic in the following regulations: Ris. Min. 167/2008, Ris. Min. 86/2006, and Ris. Min. 17/2006, *available at* http://www.finanze.it.

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

Italian tax law does not contain a definition of beneficial owner for general tax or treaty purposes. This concept is defined and used in other specific areas of Italian tax law. 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 OECD Commentary

The commentary to the OECD model convention revised in 2003 provides important clarifications on the interpretation of the term ''beneficial owner'' as used in tax treaties.

The OECD commentary directly links the concept of beneficial ownership to possible abuses of tax treaties. The beneficial ownership provision should be used to deny treaty benefits in the form of elimination or reduction of source-based withholding taxes on portfolio income such as dividends, interest, and royalties when nontreaty country taxpayers, who would not be eligible for 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, if the transaction had been consummated directly between the original payer and the final payee of the income.

Finally, since the beneficial owner requirement is applied as an antiavoidance provision, it interacts with domestic antiabuse statutory provisions or judicial doctrines aimed at contrasting similar abuses outside tax treaties. The way in which those antiabuse 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.

Beneficial Ownership: A Linguistic Survey

The concept of beneficial ownership originates from the common law and has no equivalent in civil law. This can make the application of some provisions somewhat problematic.

According to van Weeghel:

> The term ''beneficial owner'' seems to have originated in the United Kingdom, particularly through the development of trust law, under which the term ''beneficial owner'' is used as distinguished from ''legal ownership.'' So, we can assume that its archetype is the trust. In the United Kingdom, however, this term is also used also outside the trust context and in particularly in the tax law of the United Kingdom.[2]

As regards this question, van Weeghel points out: ''With the widespread use of the term 'beneficial owner,' one would expect the term to have a clearly defined meaning. Nothing, however, is further from the truth.''

The term ''beneficial ownership'' is used in common law to distinguish the rights enjoyed by persons with a beneficial interest in property from those enjoyed by the legal titleholder to that property. It is a term derived by the common-law ''equity'' regime.

According to the concept described above, the person is entitled to enjoy the economic rights stemming from the ownership although the ownership has been registered in the name of someone else (the legal owner). Accordingly, the legal owner holds the object in his own name but on behalf of the beneficial owner.

Whether those beneficial rights constitute an actual ownership right is the subject of much debate. Under civil law, there is no such fragmentation of the right of ownership. While dismemberments of ownership exist, for example, usufruct, use, servitude, and emphyteusis, these dismemberments limit or expand rights enjoyed in property but do not convey ownership itself.[3] Furthermore, none of these dismemberments of the right of ownership can be precisely analogized to the common-law concept of beneficial ownership.

The beneficial owner is the indirect owner. Therefore beneficial registration structures are known as indirect holding, nominee registration, or omnibus holding structures as opposed to the end-investor or direct holding structures.

Property law in civil law jurisdictions traditionally lacked beneficial ownership structures.

A few terminological remarks regarding beneficial owner can be useful for courts and the tax administration, not to mention taxpayers. I think that this kind of knowledge and analysis could (and should) have driven the Italian Supreme Court to a different decision in this controversy.

Beneficial owner can be defined as the true owner of a share, as opposed to any name in which it may be legally held, and as ''an owner who is entitled to the possession and use of land or its income for his own

[2]S. van Weeghel, *The Improper Use of Tax Treaties*, Kluwer Law International (1998), pp. 64-66. Van Weeghel quotes section 258 of the Income and Corporation Taxes Act 1970.

[3]*Oxford Dictionary of Law*, 4th ed. (1997).

benefit''[4]; furthermore, it can be also described as ''a person even though legal title of the property belongs to another person.''[5]

First, this term is commonly translated into Italian in different ways. According to the Inter-Active Terminology for Europe,[6] beneficial owner is the equivalent English term of the Italian *proprietario effettivo*[7] as well as of *beneficiario*,[8] and as *beneficiario attivo*.[9] This term can also be translated into Italian as simply *proprietario*.[10]

Second, from a linguistic perspective, we can assume that the Italian equivalent terms have slight differences in meaning. The Italian term for ''owner'' (*proprietario*) indicates ''whoever holds the enjoyment of ownership'' (*chi gode della proprietà di qualcosa*) while the Italian term for ''beneficiary'' (*beneficiario*) defines ''whoever holds the advantage of a judicial act'' (*chi gode i vantaggi di un atto giuridico*).[11]

Some interpreters also translate the English concept of beneficial owner to the Italian expression ''*titolare effettivo*.''[12]

Not surprisingly, all the definitions point out the power to take advantage of the juridical situation.

Conclusion

There is an evolving multilateral consensus among OECD member countries on the appropriate method for source countries to follow to determine if they should provide treaty benefits on items of income paid to fiscally transparent entities. The question is very sensitive when a conflict exists between the source and residence states.

This consensus is described in greater detail in the OECD report, ''The Application of the OECD Model Tax Convention to Partnerships,'' which generally provides that a source state is required to grant treaty benefits on income paid to an entity only if the income is considered to be derived by a resident of a treaty partner for purposes of the treaty partner's tax laws.

Therefore, if a dividend paid by a corporation that is a resident of one of the states (as determined under article 4 (Residence)) 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.

In this case there is no doubt that the Fund, in itself, was entitled.

These limitations are confirmed by paragraph 12 of the OECD commentaries to article 10, stating:

> 12. Under paragraph 2, the limitation of tax in the State of source is not available when an intermediary, such as an agent or nominee, is interposed between the beneficiary and the payer, unless the beneficial owner is a resident of the other Contracting State.

The text of the model was amended in 1995 to clarify this point, which has been the consistent position of all member countries.[13]

In the present case, the Supreme Court has argued that the reduced withholding tax provided under the Italy-Japan tax treaty only applies when the actual recipient is a resident of the contracting state (in this case, Japan), regardless of who the beneficial owner of the relevant payments is.

The premise is the right one, but the conclusion is wrong.

Generally speaking, the concept is used by the tax authorities as an antiavoidance provision; article 1 of the Tax Code states that the income tax applies to the ''possession'' of income in enumerated categories. The Italian term ''*possesso*'' as defined outside the tax law means actual ownership as opposed to mere legal title.

This concept has been used to lift the veil on situations when the mere legal title is used for avoidance purpose, not — as the Court did — to deny a benefit in a situation when it had been allowed.

To conclude, we can state that all the rules in treaties themselves can apply to limit eligibility for treaty benefits regarding investment income. However, all the rules have one primary focus. The recipient of the income must be the true economic owner of the income to qualify for treaty benefits. Thus, when structuring investments with a hope to obtaining a treaty benefit, the taxpayer must make sure that the recipient of the income shows the proper amount of economic ownership under these rules to qualify. ◆

[4] *Id.*

[5] *Black's Law Dictionary*, 2nd pocket ed. (2001), p. 508.

[6] The Inter-Active Terminology for Europe is the EU interinstitutional terminology database used for the collection, dissemination, and shared management of EU-specific terminology.

[7] Picchi, *Il nuovo Economics & Business*, Zanichelli (1999).

[8] *Id.*

[9] COM(98) 295 (2) OJ C 212/98 p. 15.

[10] Garzanti Linguistica, *Dizionario Business English* (2006).

[11] De Mauro, *Dizionario della Lingua Italiana*, *available at* http://old.demauroparavia.it/.

[12] C. Licini, *Normativa antiriciclaggio e attività notarile, Il ruolo del notaio nel sistema europeo e nazionale di lotta al riciclaggio al denaro criminale*, IPSOA (2006), p. 197.

[13] *See also* para. 24 of the OECD commentaries to article 1 (Personal Scope).