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In this article, the author discusses a decision by the Italian Supreme Court, which held that determining whether a pure holding company qualifies as a beneficial owner for tax treaty purposes requires a fact-specific analysis of the company's activities — keeping in mind its unique structure — and an examination of its authority over the income.

The Italian Supreme Court recently issued a ruling taking a substance-over-form approach to defining the term "beneficial owner" in the context of a pure holding company. In Decision No. 27113/2016, the court held that determining whether a pure holding company qualified as a beneficial owner of a given piece of income for tax treaty purposes required undertaking a functional analysis of the activities carried out by the entity in light of the nature of a pure holding company, and considering whether the entity had the full right to use and enjoy the income, unconstrained by any obligation to pass on the sums to other persons or entities.

Background of the Case

In the case before the court, a U.S. corporation owned a holding company in France, which in turn owned an Italian subsidiary. In 2002 the Italian subsidiary distributed dividends to its French parent company, withholding a 5 percent tax under article 10, paragraph 2(a) of the France-Italy tax treaty. The French holding company applied for a tax credit from the Italian tax authorities (less the 5 percent withholding tax levied at the source) under article 10, paragraph 4(b) of the same treaty.

Denying the refund, the Italian tax authorities pointed to:

- the lack of sufficient conditions to qualify the French holding company as the beneficial owner of the dividends paid by the Italian subsidiary; and
- the lack of sufficient conditions to identify France as the holding company's place of effective management.

The French holding company appealed the tax authorities' opinion to the relevant tax court. In Decision No. 328/10/10, the Regional Tax Court of Abruzzo held that in order for the French holding company to qualify as the beneficial owner of the dividends paid out by the Italian subsidiary for tax treaty purposes, it was imperative that the French company not act as a mere conduit for passing the money to the U.S. corporation. In analyzing the case at hand, the judges considered that:

- the holding company was owned entirely by a sole shareholder based in the U.S., a country that did not have a tax treaty with Italy that would provide the same dividend imputation tax credit as the France-Italy tax treaty;
- the balance sheet of the holding company did not reflect the relevant trade receivables beyond the participation in the Italian subsidiary;
- the holding company's business activities were limited to ownership of shares in the Italian subsidiary;

- the holding company lacked a minimal level of organizational structure, including personnel, offices, and assets; and
- the holding company did not have its place of effective management in France because of the lack of business substance.

Ultimately, the regional tax court found that the French holding company was acting only as a conduit company for the U.S. corporation and was part of a more comprehensive strategy designed to minimize taxation for the parent company. Hence the court held that the holding company should not be regarded as the beneficial owner for tax treaty purposes of the dividends received from the Italian subsidiary.

The case eventually came before the Italian Supreme Court (Fifth Chamber, Tax Law). In the appeal, the French holding company argued that the regional tax court misinterpreted the concepts of beneficial owner and place of effective management by failing to consider the nature of the activities carried out by a pure holding company.

Among other arguments, the appellant suggested that the France-Italy tax treaty was contrary to EU law because it violated the freedom of establishment principle of article 43 of the EC Treaty (now article 49 of the Treaty on the Functioning of the European Union), which prohibits restrictions on the ground of nationality and on the ability of nationals of any member state to set up subsidiaries in another member state.

The Beneficial Ownership Concept

Notably, neither Italian tax law nor Italian treaties establish a comprehensive definition of beneficial ownership. However, guidance was provided with the official implementation of the EU interest and royalties directive into domestic law,[1] which established that the direct recipient of an item of income qualifies as the beneficial owner if acting "as final beneficiary and not as an intermediary, such as an agent, trustee or authorized signatory for some other person" (author's translation). Further, in Circular No. 47/E of November 2, 2005 (concerning the implementation of the directive), the Italian Revenue Agency clarified that in order for a person to qualify as the beneficial owner of an item of income, the person must derive a personal economic benefit from the income received, in terms of juridical and economic ownership of the sums.

In contrast, the OECD has elaborated on the concept of beneficial ownership for tax treaty purposes in the commentary on the OECD model convention. The commentary clearly states that the direct recipient of an item of income will be regarded as the beneficial owner if it has the power to use and enjoy the sums unconstrained by any contractual or legal obligation to pass on the payments to another person.[2] This definition focuses on the power over income flow rather than the ability to direct and influence the party that makes the payment.[3]

This approach has been used by the Italian Supreme Court in the past, when it declared that:

> a conventional benefit cannot be granted unless it is not strictly connected to the circumstances that the taxpayer that will enjoy those sums, being effectively resident in that State, will also be the person having the full juridical and economic availability of the dividend cashed. [4]

However, according to the OECD, this wording should be interpreted in the context of a pure holding company,[5] which is different from an operative company in terms of level of organization, economic activity, and entrepreneurial risks.

The issue of economic reality versus artificial arrangements has been extensively debated in the Court of Justice of the European Union, and the 2006 *Cadbury Schweppes*[6] case remains the

[1] Presidential Decree No. 600 of Sept. 29, 1973, article 26-*quarter*, para. 4, lit. (c), no. 1.

[2] OECD commentary on article 10 of the model tax convention, para. 12.4.

[3] *Id.* at para. 12.3.

[4] Corte Suprema di Cassazione (Supreme Court), Case No. 25281 of Dec. 16, 2015, and Case No. 10792 of May 15, 2016. (Note: Unless otherwise noted, all translations of Italian case law into English are the work of the author.)

[5] *See* OECD commentary, *supra* note 2, at para. 12.1 (discussing conduit companies and beneficial ownership).

[6] *Cadbury Schweppes PLC v. Commissioner*, C-196/04 (CJEU 2006).

landmark decision. In its case law, the CJEU looks at the circumstances under which wholly artificial arrangements that fail to reflect economic reality can be challenged. The Court starts by examining the economic reality of the arrangements at issue (for example, physical existence in terms of premises, staff, and equipment) — in particular whether, despite a formal observance of the conditions laid down by European Community rules, the reality does not comply with the concept of freedom of establishment. The CJEU then goes on to consider whether the arrangements reflect an intention to avoid or minimize the tax normally due on the profits generated from activities outside the entity's country of residence.

The Decision and Its Impact

In its decision, the Regional Tax Court of Abruzzo suggested that the holding company's lack of economic substance should itself be interpreted as an indicator of artificiality. The court therefore viewed the holding company as a wholly artificial arrangement designed to circumvent tax treaty provisions.

Applying a substance-over-form approach, the Italian Supreme Court overruled the regional tax court. The Supreme Court's analysis considers the nature and the peculiarities of a pure holding company as well as the activities undertaken by the entity in this instance, characterized by having no significant business activities or investments, no assets, no business premises, and no personnel, and owning no shares beyond participation in the controlled subsidiary. Therefore, the mere fact that a pure holding company is not engaged in actual business activities would not be sufficient to limit its ability to carry out holding activities consistent with the EU principle of freedom of establishment. To hold otherwise would, in essence, suggest that a pure holding company can never have a valid existence, at least from a beneficiary standpoint. Hence, the application of the beneficial ownership clause should not be denied on this ground alone.

In this regard, the Italian Revenue Agency recently provided guidance supporting the right of pure holding companies to operate in the country. In Resolution No. 69/E of August 5, 2016, the tax authorities indicated that a company located in the EU should not be discriminated against on the ground of the freedom of establishment whatever the form taken by the entity. This gives pure holding companies an argument if the tax administration deems them artificial.

Ultimately, the Supreme Court held that beneficial ownership — which can be a key issue in the context of the domestic antiavoidance rules as well as the antiabuse principle of article 31 of the Vienna Convention on the Law of Treaties — should be tested, considering the nature and the functions of the direct recipient of income concerning its ability to make autonomous decisions regarding and exercise power over the funds. Therefore, in this case, understanding beneficial ownership requires considering the significant lack of operations as part of the nature of a pure holding company rather than a detrimental indicator, as it would be in the context of an operating company.

The Supreme Court also discussed the issue of the juridical and economic ownership of an item of income. In particular, the Supreme Court held that the right to claim tax treaty relief should not be limited simply because a pure holding company is wholly owned by a sole shareholder based in another country. The OECD guidance ties beneficial ownership status to a lack of legal and contractual obligations to pass the sums immediately to any other person. Hence, to limit the status of beneficial owner for tax treaty purposes to the ultimate shareholder in a long chain of control would be superficial and inconsistent with the authorized OECD approach. Further, in the author's view, simply because a dividend distribution eventually occurs following a resolution of the pure holding company's shareholders does not mean that the ultimate shareholder is the beneficial owner of the dividends. This position, like the others, is consistent with the OECD commentary, according to which obligations that "are not dependent on the receipt of the payment by the direct recipient such as an obligation that is not dependent on the receipt of the payment and which the direct recipient has as debtor" are excluded from the concept of "contractual or legal obligation."[7]

[7] *See* OECD commentary, *supra* note 2, at para. 12.4.

The Regional Tax Court of Abruzzo also held that the French holding company's lack of economic substance conflicted with the assertion that its place of effectice management for tax treaty purposes was France. The Supreme Court rejected this position. In particular, the judges argued that in line with the OECD approach, "the place of effective management of a person other than an individual is deemed to be the place where key management and commercial decisions are made." Thus, the concept must be stricly interpreted in light of the nature and functions of a pure holding company. Applying this judgment, the Supreme Court found that the French holding company had provided evidence supporting the conclusion that its place of effective management was France, given that[8]:

- the headquarters had been in France since 1946 (while the tax treaty at issue was signed in 1989 and ratified in 1992);
- the main management and administrative decisions occurred in France;
- the French tax authorities issued a certificate showing that the holding company was resident for tax purposes in France; and
- all members of the holding company's board of directors were tax residents in France.

Therefore, the Supreme Court took the position that the assessment of the holding company's status required considering the nature and function of a pure holding company, including the coordination and management of the risks, rather than focusing on the lack of an operational structure or the failure to undertake particular functions that would require a higher degree of organization.

Conclusions

As this article has illustrated, the meaning of the beneficial ownership clause as it applies to pure holding companies for tax treaty purposes will be evaluated by the Italian authorities using a substance-over-form approach. Significantly, from an Italian tax perspective (and as suggested by the commentary on the OECD model convention), the direct recipient of an item of income should be considered the beneficial owner if the person, in addition to being the legal owner of the income, has full control over the income flow. However, the Supreme Court has made it clear that the lack of organizational structure typical of a pure holding company may not be used to deny tax treaty relief. Rather, the determination of beneficial ownership should be made by considering the nature of the direct recipient of the item of income and the functions performed in its operations. ■

[8] Althought not mentioned by the Supreme Court in its decision, it is also worth noting that paragraph 25 of the "Observations on the Commentary" to article 4 of the model tax convention states that "Italy holds the view that the place where the main and substantial activity of the entity is carried on is also to be taken into account when determining the place of effective management of a person other than an individual."