NovioTax

Italian Supreme Court issues guidance on beneficial ownership conditions for pure holding companies

March 2017

Prévost, Velcro and _Cadbury Schweppes_ are being perceived as landmark cases in the context of beneficial ownership. A recent decision by the Italian Supreme Court, in which it clarifies that beneficial ownership conditions for holding companies should not be tested based on significant organizational presence, has the potential to be added to this list of "beneficial ownership landmark cases". The Italian Supreme Court corrects a misinterpretation of the concepts of beneficial ownership and place of effective management, taken into account the nature of the activities carried out by a pure holding company. Subsequently the Italian Supreme Court emphasizes that the mere lack of operational substance of holding companies (in itself) should not be an indicator of the absence of beneficial ownership.

Observing the overlap between the various provisions on treaty abuse and beneficial ownership, the actual substance of companies becomes increasingly important, especially in case of holding companies which have a limited substance due to the nature of their activities. The Italian case may provide international groups with holding companies that do not have any business activities or investments, no business premises, no personnel, and owning no shares beyond participation in the controlled subsidiary with an argument in beneficial ownership discussions with tax administrations. In this paper we have identified and clarified a number of additional considerations for international groups.

Some historical remarks

Originally, in the OECD-model tax convention of 1977, the concept of beneficial ownership was introduced as an anti-abuse provision. In recent versions of the OECD Model Tax Convention ("MTC") and its corresponding commentary, the OECD has elaborated in more detail (article 10 OECD MTC and accompanying OECD commentary) on the concept of beneficial ownership for tax treaty purposes. The recipient of an item of income is regarded as the beneficial owner based on the power to use and enjoy any sums unconstrained by any contractual or legal obligation to pass on the payments to another person. In day-to-day practice we often see any or a combination of arguments raised in *Prévost, Velcro, Indofood* and the European Court of Justice ("ECJ") cases *Cadbury Schweppes* (C-196/04), *Weald Leasing* (C-103/09), *RBS Deutschland* (C-277/09), *Part Services* (C-425/06) and *SICES* (C-155/13).

In this particular blog we have chosen (based on similarities observed in respect of the Italian case) to elaborate in somewhat more detail on the *Prévost, Velco* and *Cadbury Schweppes* cases. In *Prévost* a Swedish company (Volvo) and a UK company (Henlys) acquired a Canadian company via establishment of a Netherlands holding company ("NL HoldCo"). The NL HoldCo owned the shares of the Canadian company (Prévost), which meant that the NL HoldCo received all the dividends from the Canadian company, even though there were not any employees, assets et al at the level of NL HoldCo. In this respect, it should be noted that in case the NL HoldCo was not interposed, Canada would be entitled to withhold a higher rate of dividend withholding tax ("WHT") observing the Double Tax Avoidance Agreements ("DTAAs") between Canada and Sweden and Canada and the UK. Subsequently, the Canadian tax authorities considered there was an improper use of the DTAA Netherlands - Canada (e.g. treaty shopping) and accordingly denied treaty benefits arguing that the particular item of income sourced in Canada was not beneficially owned by NL HoldCo.

Ultimately, the Canadian Federal Court came to the conclusion that NL HoldCo was not a nominee or agent for its shareholders. The NL HoldCo was not a party to the shareholders agreement and there was no evidence that the dividend from Prévost were predestined dividends for the shareholders. Importantly, until the management board of the NL HoldCo declared an interim dividend, which needed to be approved by the shareholders, the funds continued to be assets owned by NL HoldCo. All circumstances considered, NL HoldCo assumed the risks observing that the assets were available to its (e.g.

NL HoldCo's) creditors. Hence, NL HoldCo was the beneficial owner and was entitled to the DTAA Netherlands - Canada tax benefits, which meant, according to article 10 of the DTAA Netherlands - Canada, that these dividends were taxed at source in the Netherlands (5%). It should be noted that in this particular case there was no debate concerning the place of effective management of NL HoldCo even though NL HoldCo did not have any premises, staff and equipment.

The Velcro case dealt with the meaning of beneficial ownership in the context of royalties. Velcro Canada entered into an agreement with Velcro Industries (which was a resident of the Netherlands at that time). Velcro Canada paid royalties to Velcro Industries and withheld 10% royalty WHT (based on the DTAA Netherlands - Canada). Following a reorganization however, Velcro Industries became a resident of the Netherlands Antilles and a new Netherlands (resident) enterprise, Velcro Holdings, was included in the Velcro group of companies. Velcro Holdings received royalties, based on a percentage of net sales from Velcro Canada and paid them to the Antilles Velcro Industries company. Apparently, Velcro Holdings was a conduit company. It however ended up owning roughly 10% of the royalties and owning the royalties in the same bank account as other assets (mixed assets). Hence, despite the fact that there was a contractual obligation to pay royalties, there was no pre-arranged automatic flow of royalties between Velcro Canada and Velcro Industries. The Canadian Federal Court decided that the Dutch holding company possessed, used and controlled the royalties, which meant that this firm was the beneficial owner.

More recently, the issue of economic reality versus artificial arrangements has been debated in the ECJ (see for instance *Weald Leasing* (C-103/09), *RBS Deutschland* (C-277/09), *Part Services* (C-425/06) and *SICES* (C-155/13)). In 2006, the ECJ published its landmark decision in *Cadbury Schweppes* (C-196/04). In this case the ECJ discussed the circumstances under which wholly artificial arrangements without economic reality can be challenged. In this respect, the ECJ discusses physical existence in terms of premises, staff and equipment, and checks whether this reality check complies with the freedom of establishment. The ECJ thereafter discussed whether the arrangements reflect an intention to avoid or to minimize tax. Hence, and in particular interesting for holding companies, the (objective) elements on the basis of which parties can prove that an economic reality physically exists are reflected in terms of premises, staff and equipment.

What happened in the Italian case?

A US corporation owned a holding company in France ("French HoldCo") that in turn owned an Italian subsidiary. The Italian subsidiary distributed dividends to its French parent company and withheld 5% dividend WHT (article 10,2(a) DTAA France - Italy). The French HoldCo applied for a credit from the Italian dividend WHT based on (article 10,4(b) DTAA France - Italy). The Italian tax authorities however denied the refund.

The reasoning from the Italian tax authorities as well as the Regional Tax Court of Abruzzo (Decision No. 328/10/10), was surprising if we consider the existing case law in combination with the OECD guidelines pointed out before. As neither the Italian treaties in force nor the domestic law contain a definition on "beneficial ownership", the Italian tax authorities generally rely on the OECD guidelines and existing international case law. Interestingly, both the Italian tax authorities as well as the Regional Tax Court adhered significant attention to the lack of operational substance of the French HoldCo. Apparently the French HoldCo could not be considered as having its place of effective management in France because of the lack of substance. The French HoldCo did not have any premises, staff and equipment and its balance sheet did not record any trade receivables beyond its participation in the Italian subsidiary. In addition, the Regional Tax Court observed that the French HoldCo was wholly owned by a US company, a country that did not have a tax treaty with Italy and therefore would not provide similar tax benefits as granted by the DTAA France - Italy. On that basis, French HoldCo was a mere conduit set-up to minimize tax leakage on upstreamed income.

In our opinion this reasoning is based on a misinterpretation of the concepts of beneficial owner and place of effective management by failing to consider the nature of the activities carried out by French HoldCo. Based on for instance *Prévost* and *Cadbury Schweppes*, the Italian tax authorities should have interpreted the concept of beneficial owner considering the (limited) nature of the activities carried out by French HoldCo and should have focused on the power to use and enjoy any sums (dividends) unconstrained by any contractual or legal obligation to pass on the payments to another person.

Italian Supreme Court decision

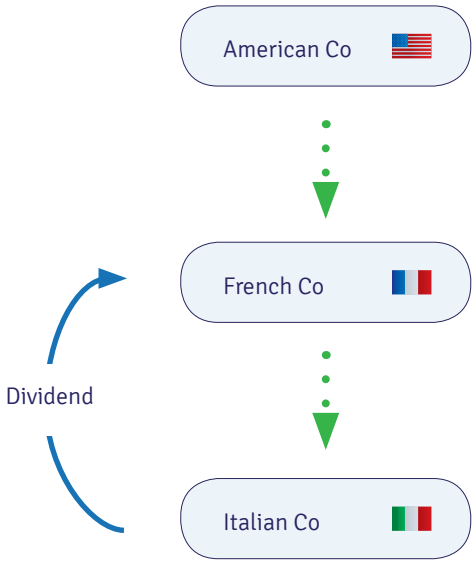
Eventually, the case came before the Italian Supreme Court who overruled the Regional Tax Court decision. The Italian Supreme Court observed the nature of the (limited) activities carried out by French HoldCo, which did not have any premises, staff and equipment and (only) owned a controlled majority investment in an Italian company. These limited holding activities however were insufficient to conclude that the French HoldCo did not have a valid residency (from a beneficiary

position). This may provide 'pure' holding companies with an argument if their residency is challenged. More interestingly however, the Italian Supreme Court indicated that beneficiary ownership should be tested observing the nature and the functions of the recipient of income in its ability to make decisions and exercise power over the applicable funds.

Subsequently, in interpreting beneficial ownership of dividend income in respect of holding companies, the lack of operational business of these companies should be considered. The mere lack of operational substance of holding companies however should not (in itself) be an indicator of the absence of beneficial ownership (as considered by the Italian tax authorities). In addition, in the case at hand, the Italian Supreme Court concluded that the place of effective management of French HoldCo was France. In doing so, the Supreme Court applied the concept of effective management strictly and in line with the nature and function of a pure holding company. In this respect we note that the French HoldCo had been in France since 1946 (well before the DTAA France – Italy came into force), that the French tax authorities issued a certificate of residence and that all board members of the French HoldCo were tax residents in France.

Key question for MNEs

The Italian case is not a landmark case along the lines of *Prévost, Velcro* and *Cadbury Schweppes*. The Italian Supreme Court merely corrects a misinterpretation of the concepts of beneficial owner and place of effective management, taken into account the nature of the activities carried out by a pure holding company, which is different from an operative company in terms of economic activity and entrepreneurial risks. Hence, the mere lack of operational substance of holding companies (in itself) should not be an indicator of the absence of beneficial ownership. Although not being a landmark case, the decision by the Italian Supreme Court clarifies that beneficial ownership conditions for holding companies should not be tested based on significant organizational presence. This may provide international groups with holding companies that do not have any business activities or investments, no business premises, no personnel, and owning no shares beyond participation in the controlled subsidiary with an argument in beneficial ownership discussions with tax administrations.



We however note that there is a thin line between the concepts of beneficial ownership and place of effective management in cases involving holding companies. In addition, there is often an overlap between the various provisions on treaty abuse and beneficial ownership. In this context, the actual substance of a company becomes increasingly important, especially in case of holding companies, which naturally have a limited substance due to the nature of their activities. The activities performed by directors of such holding companies are a "useful starting point" for interpreting both beneficial ownership as well as central management and control (or the effective place of management). In holding companies that only have controlled participations, this difference is even more difficult. The directors of such companies should naturally be involved with the flow of income related to the controlled subsidiaries in performing their management activities. If the directors have very narrow powers in relation to the income concerned, or act as a mere fiduciary or administrator outsider (e.g. shareholder dictates or controls the decisions in respect of the flow of income) on account of the ultimate owners, the holding company can normally not be regarded as the beneficial owner (see also the OECD Commentary on article 10). In this respect the mere legal power or authority to manage a company's subsidiaries is not sufficient, particularly where this authority is not used.

In addition and from a comprehensive point of view, managers of holding companies should have some kind of discretionary involvement in lower-tier subsidiaries. For instance, the Netherlands non-resident taxation rules (that interestingly follow-up on the ECJ Court cases) as adopted in article 17 of the Dutch Corporate Income Tax Act 1969 have an enterprise test. In this respect and among other requirements, a substantial interest (i.e. participating share involvement via a foreign holding company) needs to be allocated to the business enterprise carried on by a foreign company. Based on the Parliamentary discussions and a recent court case it should be noted that the Dutch tax authorities will verify to what extent the shares owned by foreign entities are 'functionally attributable' to such enterprise. The latter is a factual test on which the parliamentary discussions offer little guidance. If for instance the directors of the holding entity are also directors elsewhere in the group this will be perceived as a positive factor. It is also recommended that directors of holding entities will be involved in the trading activities and the (strategic) management of the group and sufficient documentation exists to demonstrate this.

Ultimately, the key question is whether or not the people with formal decision-making authority are actual capable of retaining the dividends received, as opposed to having the obligation to pass the income over to the next entity in the group. To demonstrate that holding companies are not influenced by shareholders decisions and to avoid misinterpretations between the concepts of beneficial ownership and effective place of management, it may be preferable to:

- embed holding companies within the organizational structure (e.g. perform a sanity check);
- arrange that directors of holding companies have the required skills, experience and qualifications to perform their duties and have sufficient knowledge of the business to make informed decisions;
- record board minutes in more detail (e.g. not only what decisions are made, but also why the directors made them);
- monitor functional attribution between holding entities and lower-tier subsidiaries (i.e. integrated strategic management et al);
- assume that a creditor risk exists, based on the notion that dividends received are available to its creditors (Prévost) and aggregate any income received (if applicable: Velcro); and
- appoint only local directors and maintain / establish long-term ownership structures (Italian case).

ABOUT NOVIOTAX

NovioTax is a Dutch research-oriented tax consultancy firm with offices in Amsterdam and Nijmegen. Our employees are members of the Dutch Association of Tax Advisers (NOB) and the International Fiscal Association (IFA), have many years of experience and some are much sought-after guest speakers on tax policy and other topics that fall within their field of expertise. We typically serve midsized and large MNE clients, coordinate discussions with the DTA and closely cooperate with international law and tax law firms.

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