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Participation exemption regimes could cost WHT reliefs under EU Parent-Subsidiary Directive and DTAAs

January 2021

Following some recent Italian Supreme Court rulings, uncertainty remains as to the position of the Italian Revenue Authority on the Withholding Tax Exemption under the EU Parent-Subsidiary Directive and the bilateral tax treaties concluded between Italy and other EU Member States. This blog considers (i) these developments, (ii) the influence of EU case laws on this matter, (iii) the cross-border relief measures and (iv) the impact on holding companies that may (potentially) be exposed to (significant) dividend withholding tax leakage.

This blog clarifies the recent Italian Supreme Court rulings on, among other requirements, the effect of participation exemption regimes in the EU. These rulings deal with the exemption of withholding tax ("WHT") on dividends in Italy, based on: the EU Parent-Subsidiary Directive, Italian bilateral tax treaties ("DTAAs") and the participation exemption regimes applied in the resident state of the recipient of the dividends. In this regard, cases with a focus on Dutch and Luxembourg holding companies and their respective participation exemption regimes have been selected. These regimes are relatively generic in nature and should, if the requirements of the participation regimes be met, exempt dividends.

I. INTRODUCTION

The EU Parent-Subsidiary Directive deals with elimination of economic double taxation arising within a group of companies from cross-border distributions of profits i.e. from EU subsidiaries to EU parent companies. The fourth preamble of the EU Parent-Subsidiary Directive states the need to create within the EU "conditions analogous to those of an internal market" and to "ensure the effective functioning of the common market". The elimination of economic double taxation is a necessary precondition to achieving the aforementioned objectives. Accordingly, the EU Parent-Subsidiary Directive provides – under certain conditions – an exemption from withholding tax in the State of the subsidiary, as well as an obligation for the State of the parent company to either exempt or grant an underlying tax credit (offsetting the taxes paid at the level of the subsidiary). Due to the elimination of the withholding tax in the State of the subsidiary, it is clear that the elimination of the juridical double taxation is also an indirect effect of applying the EU Parent-Subsidiary Directive.

The EU Parent-Subsidiary Directive only applies to distributions of profits by an EU subsidiary to its EU parent company, if all of the requirements are met (e.g. a minimum holding period, a minimum shareholding, a tax residency in EU Member State and a 'subject-to-tax' requirement). Art. 2(a)(iii) of the EU Parent-Subsidiary Directive also dictates a subject-to-tax requirement which has been, for the large part, a disputed point in these cases. The requirement provides two conditions (at the level of both the parent company and the (distributing) subsidiary): (i) a positive condition, i.e. the relevant company must be subject to Corporate Income Tax ("CIT") and (ii) a negative condition, i.e. the relevant company must not be exempt from tax and not have the possibility of an option for an exemption.

In this blog we will only focus and comment on the requirements that may impact Dutch holding companies and that have been addressed in the Italian Supreme Court cases. We will also comment specifically on the subject-to-tax requirement in relation to the Netherlands participation exemption.

II. CLARIFICATION ON NETHERLANDS PARTICIPATION EXEMPTION

Pursuant to a confirmation that the profit entitlement of a subsidiary exceeds the 5% ownership criterion, a Dutch tax resident (parent) company will be able to apply the participation exemption on its investment(s) if either one or a combination of the following tests is satisfied:

- *Motive test:* A participation is held as a portfolio investment if it is held with the motive of obtaining a return that may be expected from normal asset management. This test is determined based on the facts and circumstances. If it is not certain that the Motive Test is satisfied the participation exemption may still apply if either the Subject-to-Tax Test or the Asset Test is satisfied.
- *Subject-to-Tax Test:* The Subject-to-Tax Test is satisfied if the subsidiary is subject to a profit tax that results in a 'realistic levy' based on Dutch tax principles. In comparing the tax rate, a statutory rate of at least 10% is the starting point. Typically, the calculation for the Subject-to-Tax Test is made on the basis of domestic tax standards, as long as these domestic standards lead to taxation similar to the taxation under Dutch tax legislation. In case there are no special differences in the tax base or other differences that result in an effective tax rate lower than 10%, then the subsidiary should be subject to a 'realistic levy'. Reasonably speaking any Dutch company owning at least a 5% ownership in an Italian (non-transparent) company will be able to satisfy the Subject-to-Tax Test.
- *Asset Test:* For the Asset Test it should be established whether the assets of the participations (direct or indirect) usually predominantly (i.e. for more than 50%) consist of other assets than 'low-taxed portfolio investments'. The Asset Test should be based on the fair market values. The Asset Test is met if less than 50% of the assets of the subsidiary (direct or indirect) generally consist of low-taxed free portfolio investments. In case of active companies reasonably speaking the Asset Test should be satisfied.

III. ITALIAN SUPREME COURT CASES

The Italian Supreme Court denied the application of the benefits of the EU Parent-Subsidiary Directive consisting in an exemption from withholding tax on the distribution of dividends to holding companies resident in the Netherlands and Luxembourg, in cases 25264/2017 (25 October 2017) and 25490/2019 (10 October 2019), respectively.

Case 25264/2017 (25 Oct 2017)

In this case, the Italian company (ITCo.) was owned by a Dutch Public Limited Company (*Naamloze Vennnootschap* or N.V.) (NLCo.). IT Co. distributed a dividend to NLCo. and withheld a reduced 5% WHT on dividend (observing the Italy-Netherlands DTAA). NLCo. requested for a refund of the 5% withheld based on the EU Parent-Subsidiary Directive. The Italian Revenue Authorities rejected the refund and instead issued additional assessments for the full amount of dividend WHT (observing the domestic Italian dividend WHT of 27%). The Italian Revenue Authorities argued that NLCo. had failed to satisfy the requirements of both the EU Parent-Subsidiary Directive and the Italy-Netherlands DTAA. At the level of NLCo. the dividend had been exempted (from CIT) by virtue of the Netherlands participation exemption. In addition, it had not submitted a valid evidence for the beneficial ownership of the dividend. NLCo. appealed to the Italian Supreme Court. The Italian Supreme Court ruled in favour of the Italian Revenue Authorities (although NLCo. had provided a tax residency certificate issued by the Dutch Revenue Authorities).

Case 25490/2019 (10 Oct 2019)

In this case, a Luxembourg Company (LuxCo.) owned by an Australian multinational independent investment bank and financial services company (AusCo.), acquired 44.74% of an Italian company named S.p.A (ITCo.) that operates Roma's airport. ITCo. distributed a dividend to LuxCo. and withheld a reduced WHT of 15% based on the Italian-Luxemburg DTAA. LuxCo. requested for a refund of the 15% dividend WHT withheld based on the EU Parent-Subsidiary Directive. The Italian Revenue Authorities rejected the refund request and instead issued additional assessments based on the domestic Italian dividend WHT (i.e. 27%). LuxCo. and the Italian Revenue Authorities proceeded the matter (via the Provisional Tax Commission and the Appellate Tax Court) to the Italian Supreme Court.

The Italian Supreme Court concluded that LuxCo. was a wholly artificial arrangement, and, accordingly was not entitled to the benefits of the EU Parent-Subsidiary Directive. The Italian Supreme Court considered the Luxembourg participation exemption as a beneficial regime that cannot be combined with the Italian dividend WHT exemption. This reasoning should in our opinion be considered in light of the abusive structure (as concluded by the Italian Supreme Court). In addition, it is commonly understood that source countries are allowed (which is based on Art. 1(2) EU Parent-Subsidiary Directive) to disallow a dividend WHT exemption in cases involving abuse. In this case, the Luxembourg ownership structure may have been implemented to benefit from the Luxembourg dividend participation regime and to reduce tax leakage (vis-à-vis the owners of LuxCo.).

IV. ARGUMENTS TO BE CONSIDERED

CJEU Wereldhave (C-448/15)

It is not certain whether the aforementioned Italian Supreme Court cases align with case law of the Court of Justice of the European Union (CJEU). In *Wereldhave* (Case C-448/15) the CJEU denied the benefits of the EU Parent-Subsidiary Directive in respect of two Dutch companies subject to CIT at a rate of 0%. In *Wereldhave*, a Belgian SICAFI (i.e. a Belgian REIT) distributed a dividend to its Dutch shareholders. The Dutch shareholders were eligible to the so-called FBI-regime ("Fiscale Beleggingsinstellingen"). The Dutch shareholders were in principle subject to Dutch CIT. The rate applied was 0%, provided that all dividends received were on paid to the owners of the FBI (i.e. an FBI has a distribution requirements). The CJEU disallowed the entitlement to the EU Parent-Subsidiary Directive and, accordingly, disallowed the application of the Belgium dividend WHT exemption. The FBI's were not able to satisfy the 'subject-to-tax' requirement as they were not actually liable to pay tax and were not able to meet the 2nd part of the subject-to-tax requirement (as the FBI's were eligible to a preferential CIT treatment in the Netherlands). The CJEU reasoned that for FBIs there was no risk of double taxation (as the CIT rate was 0%). Hence, there was no need to apply the EU Parent-Subsidiary Directive.

The CJEU ruling in the *Wereldhave* case implied that the exemption or the possibility of an option referred to in the 2nd part of the subject-to-tax requirement of the EU Parent-Subsidiary Directive should apply strictly to full exemption from CIT (as is the case with FBIs). Accordingly, it could be reasoned that the 2nd part of the subject-to-tax requirement should not apply to a participation exemption regime exempting a specific item of income (i.e. a dividend), like the Netherlands participation exemption.

Considering *Wereldhave* it could be argued that the subject-to-tax requirement must be interpreted as a general liability to tax and that the requirement would be satisfied if the recipient of the dividend is (i) a separate entity for tax purpose and (ii) is generally/potentially liable to a CIT, even though, as in the case of Dutch holding companies, no tax is paid in relation to a specific item of income like a dividend (due to the participation exemption regime). In view of *Wereldhave*, the position taken by the Italian Supreme Court in the Dutch case (Case 25264/2017) seems restrictive. NLCo. was subject to the Dutch CITA (25% CIT rate) and applied the Dutch participation exemption regime to avoid that the dividends would have been taxed twice in Italy and the Netherlands.

CJEU Securities (C-389/18)

It could also be argued that the Italian Revenue Authorities differentiate between a cross-border distribution of a dividend by an Italian subsidiary to a parent company in an EU Member State and the distribution to an Italian parent company. If and to the extent domestic Italian dividends are not taxed twice with Italian CIT (which we assume), disallowing the benefits of the EU Parent-Subsidiary Directive to cross-border dividends may be contrary to the freedom of establishment (art. 49 and 54 of the Treaty on the Functioning of EU (TFEU)). Effectively non-Italian companies would have a disadvantage in establishing Italian companies compared to Italian parent companies.

A denial of dividend WHT exemptions in cross-border cases in comparison to purely domestic cases could (in our opinion) only be justified in abuse situation. This would also align the EU Parent-Subsidiary Directive with settled CJEU case law. The main purpose of the EU Parent-Subsidiary Directive is to prevent a different treatment of dividends distributions within the EU compared to purely domestic situations. Reference is made to the *Securities* case (C-389/18).

In the *Securities* case, a Belgian company (BelCo.) received dividends from a subsidiary in the EU Member State. Based on the Belgium implementation of the EU Parent-Subsidiary Directive the dividends received were included in the tax base and subsequently a deduction of 95% was applied. Belgian tax law also provided that the deduction must be applied before other deductions (which were limited in time). BelCo. argued that the Belgium recognition and deduction mechanism effectively (as in, in relation to other adjustments) resulted in a higher tax burden on the parent company than compared to the exemption system envisaged in the EU Parent-Subsidiary Directive. Hence, the Belgium implementation of the EU Parent-Subsidiary Directive did not result in tax neutrality.

CJEU Danish cases (a.o. C-118/16)

In relation to the Luxembourg case we note that the participation exemption regime (in that case) seems to be more an indication of abuse (as it may enable a tax free repatriation of income vis-à-vis the shareholders of LuxCo.) and not necessarily a question whether prima facie the Luxembourg participation exemption regime should trigger complications in respect of the 2nd part of the subject-to-tax requirement. From the outset the Luxembourg case may align with (part of the) *Danish* cases. Compare for instance C-118/16 – in this case an exemption of CIT of an interest amount disabled the application of the EU Interest and Royalties Directive.

Amendments to the Netherlands participation exemption regime

In addition to the above, it should be noted that the Dutch CIT Act ("CITA") contains several anti-abuse provisions. Some of these provisions (for instance article 13ab CITA) have been implemented as a result of the EU Anti-Tax Avoidance Directive ("ATAD"). ATAD tackles cross-border tax avoidance by providing a set of rules in order to implement the OECD's base erosion and profit shifting project ("BEPS") in a coordinated manner. As of 1 January 2019, the Dutch participation exemption does not apply in, for instance, situations involving (non-distributed passive) income of Controlled Foreign Companies ("CFC").

This factually implies a switch-over provision in relation to low-taxed passive (non-distributed) income. To fall under the scope of the CFC legislation, the activities must take place in a country listed on the EU non-cooperative countries list and/or on the Dutch list of low-taxed countries. Hence, it should be noted that the "subject-to-tax requirement" of the EU Parent-Subsidiary Directive needs to be understood (also) in light of (for instance) ATAD and other provisions aimed at implementing the proposals in relation to the OECD's BEPS project. This may impact the subject-to-tax requirement of the EU Parent-Subsidiary Directive and makes the Netherlands participation exemption less generic.

WHT relief under DTAA as second best alternative to EU Parent Subsidiary Directive?

Noticeably, most DTAAs employ the "liable to tax" requirement, in contrast to the 'subject-to-tax requirements, in determining a 'resident person' for tax purposes[1]. The Netherlands-Italy DTAA (1993) also uses the same requirement under Article 4 to define a 'person resident in either Netherlands or Italy or both'. Under the "liable to tax" requirement, actual payment of tax is not required. The mere fact of being potentially liable to tax under the CITA is sufficient, at least, to claim tax benefits under the DTAA. The DTAA and the EU Parent Subsidiary Directive have been designed for different purposes, i.e. to avoid juridical double taxation and eliminate economic double taxation, respectively. Hence, there should be no ground to apply the 'subject-to-tax' requirement of the EU Parent Subsidiary Directive to deny WHT reliefs under DTAAs.

Therefore, if a parent company fails to meet the "subject-to tax requirement" under the EU Parent Subsidiary Directive for WHT exemption, it may still enjoy the WHT relief (i.e. reduced rate) under the applicable DTAA as a second best alternative. Accordingly NLCo., in the case 25 October 2017, could have considered to apply the Netherlands-Italy DTAA. This could have provided for a 5% dividend WHT (subject to other conditions).

V. CONCLUDING REMARKS

- It is recommended (if possible) to monitor the developments of case law of the Italian Supreme Court. Along with this, Dutch parent companies with Italian subsidiaries may consider pausing distributions of dividends. In addition, Netherlands companies, to the extent that Italian WHT has already been withheld may consider requesting a refund of Italian WHT (based on the application of the relevant DTAA and/or the EU Parent-Subsidiary Directive).
- It is questionable whether the Italian Supreme Court cases align with case law of the CJEU. Observing *Wereldhave* (Case C-448/15) the position taken by the Italian Supreme Court in the Dutch case (Case 25264/2017) seems somewhat restrictive as the Court appears to disregard economic double taxation. Allowing the benefit of the exemption from withholding tax in Italy to a condition that dividend actually be taxed in the State of residence of the parent company (i.e. Netherlands) does not appear to be in accordance with the scope of the EU Parent-Subsidiary Directive.
- Based on *Wereldhave*, the EU Parent-Subsidiary Directive does not apply to companies that are not liable to pay one of the listed taxes, such as investments funds that are subject to zero corporate tax rate, which is equivalent, in practical terms, to a full exemption from tax. This is not the case for NLCo. or of the Dutch parent companies benefitting from the participation exemption. A Dutch holding company is not subject to a tax rate of 0% (like the Dutch companies in Wereldhave that applied the FBI-regime) but merely benefits from an objective exemption that applied to a specific item of income (dividends).
- It could be argued (based on *Securities* C-389/18) that the distinction made by the Italian Revenue Authorities between the cross-border distribution of a dividend to a parent company in an EU Member State and the distribution to an Italian parent company is contrary to the freedom of establishment (art. 49 and 54 TFEU). A denial of dividend WHT exemptions in cross-border cases in comparison to purely domestic cases could (in our opinion) only be justified in abuse situation.
- It could (also) be argued that the subject-to-tax requirement under the EU Parent Subsidiary Directive does not apply to the DTAA's. DTAA's and the EU Parent Subsidiary Directive have been designed for different purposes (to avoid juridical double taxation and eliminate economic double taxation respectively). If a parent company fails to meet the "subject-to tax requirement" under the EU Parent Subsidiary Directive for WHT exemption, it may still enjoy the WHT relief (i.e. reduced rate) under the applicable DTAA as a second best alternative. Conceptually it may consider filing for a refund based on the Netherlands-Italy DTAA.

Following the *Danish* cases (C-115/16, C-116/16, C-117/16, C-118/16, C-119/16 & C-299/16) of the CJEU the interpretation of "abuse of law" and "artificial arrangements" seems to have shifted somewhat. The CJEU explicitly noted that a group of companies may be regarded as being an artificial arrangement where it is not set up for reasons that reflect economic reality, its structure is purely one of form and its principle objective is to obtain a tax advantage running counter to purpose of the applicable tax law. Such may be the case if a holding entity is set-up to avoid withholding tax (like perhaps the LuxCo. case).

[1] Article 4(1) of the OECD Model Tax Convention on Income and on Capital (2017) uses the "liable to tax" requirements in defining a resident person.

Accordingly, in a post-BEPS environment the Italian Supreme Court cases align, to a certain extent, with the position of the Danish Revenue Authorities (resulting in the Danish cases, you can find our detailed blog on these cases here) and the German Revenue Authorities (resulting in Deister and Juhler Holding; C-504/16 and C-613/16, you can find our detailed blog on these cases here). Revenue Authorities generally closely examine all facts in relation to holding companies and ownership structures may be challenged based on beneficial ownership, abusive purposes and tax residency. An economic nexus accompanies with a material integration between holding companies and subsidiaries may support the ownership of shares and may limit adverse tax consequences.

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