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Italian Supreme Court Ruling on the Concept of Beneficial Ownership

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Oliver R. Hoor, Andrea Raschella and Rodrigo Ruberti of ATOZ Tax Advisers discuss a decision of the Italian Supreme Court on the interpretation of beneficial ownership which should have a far-reaching impact and contribute to legal certainty in the post-BEPS era.

The Italian Supreme Court released its decision in case no. 14756 regarding the interpretation of the concept of beneficial ownership on July 10, 2020. This concept was relevant when analyzing the potential application of a withholding tax exemption on interest paid by an Italian company to its Luxembourg parent company.

Under Italian tax law, interest payments made by Italian companies to nonresident companies are generally subject to a final withholding tax at a rate of 26%, unless a withholding tax exemption applies.

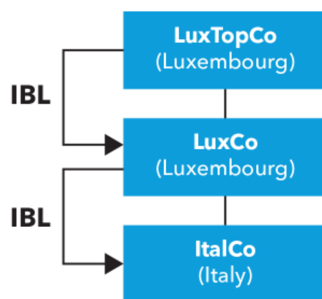
Interest payments made by an Italian company to an associated company (two companies are "associated companies" if (i) one of them directly holds at least 25% of the voting rights of the other or (ii) a third EU company directly holds at least 25% of the voting rights of the two companies) resident in another EU member state may benefit from a withholding tax exemption in accordance with the domestic law implementing the EU Interest and Royalty Directive (IRD). This withholding tax exemption is, however, conditional on the recipient of the interest payment being the beneficial owner thereof (the relevant companies must have a legal form listed in the Annex of the Directive and be subject to corporate income tax. In addition, a one-year holding period is required).

The decision of the Italian Supreme Court follows a decision of the Court of Justice of the European Union (CJEU) which dealt with a number of Danish cases where the interpretation of the concept of beneficial ownership and the application of the IRD had to be considered by the CJEU in regard to the joined cases N Luxembourg 1 (C-115/16), X Denmark A/S (C-118/16), C Denmark I (C-119/16) and Z Denmark ApS (C-299/16), ("CJEU Decision of February 26, 2019").

1. Key Facts of the Case

The case concerned a group of companies where a Luxembourg company (LuxCo) held an Italian company (ItalCo), against which it held a loan granted in the frame of a broader merger leveraged buy-out transaction performed to ultimately acquire Italian and Swedish target companies. LuxCo was owned by a Luxembourg parent company (LuxTopCo) which financed the acquisition of LuxCo by a mixture of equity and debt.

LuxCo performed financing activities and granted an interest-bearing loan (IBL) to ItalCo. The IBL was financed by an IBL granted by LuxTopCo to LuxCo.



Interest paid by ItalCo to LuxCo should benefit from an exemption from Italian withholding tax under the domestic law implementing the IRD, provided that LuxCo is the beneficial owner of the interest income.

However, the Italian tax authorities challenged the beneficial ownership position of LuxCo and on this basis the application of the interest withholding tax exemption, stating that LuxCo was a mere conduit company. The arguments set out by the Italian tax authorities included, inter alia:

- LuxCo performed only holding, financial and treasury functions;
- LuxCo granted a loan to ItalCo under conditions similar to those of the loan granted by LuxTopCo to LuxCo;
- LuxCo transferred the interest received from ItalCo after a short period of time to its controlling shareholder LuxTopCo; and
- LuxCo only realized a limited remuneration on its financing activity corresponding to 0.125% of the financing volume.

2. The Concept of Beneficial Ownership

The IRD subjects the withholding tax exemption to the condition that the beneficial owner of the income is established in another EU member state or is a permanent establishment situated in another member state belonging to a company of a member state.

With regard to the interpretation of the beneficial ownership concept as provided in the IRD, the CJEU ruled that member states cannot refer to concepts of national law which may vary in scope (CJEU Decision of February 26, 2019). This is consistent with the opinion of the Advocate General which called for an autonomous interpretation of the beneficial ownership concept in an EU context.

According to the CJEU, the concept of “beneficial owner of the interest” within the meaning of the IRD must be interpreted as designating an entity which actually benefits from the interest that is paid to it. Article 1 (4) of the IRD confirms this reference to economic reality by stating that a company of a member state is only to be treated as the beneficial owner of interest or royalties if it receives those payments for its own benefit and not as an intermediary, such as an agent, a trustee or an authorized signatory for another person.

The CJEU confirms that regarding the interpretation of the concept of beneficial ownership, EU member states may also consider the guidance provided in the Commentary to the Organisation for Economic Co-operation Development Model Tax Convention on Income and Capital (“OECD Model Tax Convention”). The Court further clarifies that the mere fact that the company which receives the interest in a member state is not its beneficial owner does not necessarily mean that the exemption provided in the IRD is not applicable. Instead, if the beneficial owner which ultimately receives the income satisfies all the conditions of the IRD, the exemption has to be granted.

According to the opinion of the Advocate General, a recipient of interest income who collects the interest in his own name and on his own account (i.e. own benefit) is the beneficial owner. Assuming that the recipient of interest generally collects interest in his own name, the decisive question is whether that interest is being drawn on account or on behalf of a third party. A person who can decide alone on the appropriation of the interest and who bears the risk of loss is acting on his own account, while a person who is bound to a third party in such a way that the third party ultimately bears the risk of loss is acting on behalf of a third party.

A conduit company is not normally 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 party" (see paragraph 10.1 of the Commentary to Article 11 of the OECD Model Tax Convention).

According to the Advocate General, a refinancing agreement concluded with a third party on similar terms and at a similar time (like in the present case) would not, of itself, suffice to assume that a trust relationship exists. Instead, more extensive ties would need to exist which limit the existing powers of the receiving company vis à vis third parties.

A company which performs financing activities should generally be considered as the beneficial owner of the interest income if the following conditions are met:

- the company bears the credit risk in relation to the financing activities;
- the company realizes an arm's length remuneration for the functions performed and the risks assumed. Thus, the amount of interest income should exceed the amount of interest expenses;
- the company may cover the costs incurred in relation to the financing activities;
- the company has no legal obligation to pass on the interest income to a third party. Ideally, it is clearly stated in the legal documentation that the finance company may freely enjoy the income and the payment of interest expenses is subject to approval by the board of directors;
- from a commercial perspective, it may also make sense not to negotiate identical terms (different maturity, different interest accrual periods, etc.) so as to reinforce beneficial ownership;
- from a practical perspective, the finance company may keep the funds for some time in its bank account. Nevertheless, a finance company needs to be careful not to incur too many interest expenses in this respect, since otherwise it might be difficult to cover the costs and to realize an arm's length profit.

3. Decision of the Italian Supreme Court

The Italian Supreme Court confirmed the decision of the Court of Appeal (the Italian tax court of second instance) and ruled that LuxCo had to be regarded as the beneficial owner of the interest paid by ItalCo.
In its decision, the Italian Supreme Court explicitly referred to the judgment of the CJEU in the joined cases (CJEU Decision of February 26, 2019) in particular, the following aspects were highlighted:

- the proof of an abusive practice requires a combination of objective circumstances and a subjective element. Accordingly, whether the purpose of the EU rules has (not) been achieved despite formally meeting the conditions laid down thereunder, and whether there was an intention to benefit from an advantage provided under EU rules through artificially meeting the specified conditions laid down for obtaining it, has to be analyzed (paragraph 124, CJEU Decision of February 26, 2019);
    - the artificiality of an arrangement is capable of being borne out by the fact that the relevant group of companies is structured in such a way that the company which receives the interest paid by the debtor company must itself pass it on to a third company which does not fulfill the conditions for the application of the IRD, with the consequence that it only makes an insignificant taxable profit when it acts as a conduit company in order to enable the flow of funds from the debtor company to the entity which is the beneficial owner of the sums paid (paragraph 130, CJEU Decision of February 26, 2019);
    - the fact that a company acts as a conduit company may be established when its sole activity is the receipt of interest and its transmission to the beneficial owner or to other conduit companies (paragraph 131, CJEU Decision of February 26, 2019);
    - a national authority is not required to identify the entity or entities which it regards as being the beneficial owner(s) of the interest in order to deny the status of beneficial owner to a given entity (paragraph 145, CJEU Decision of February 26, 2019);
- three conditions must be met to identify the beneficial owner: 1) the company must have one of the forms listed in the annex to the IRD, 2) it must, in accordance with the tax laws of a member state, be considered as a resident in that member state and not be considered, within the meaning of a double taxation convention, as a resident for tax purposes outside the EU, and 3) it must be subject to one of the taxes listed in Article 3(a)(iii) of the IRD without being exempt (paragraph 147, CJEU Decision of February 26, 2019).

The Italian Supreme Court stressed that the direct recipient of the interest is not the "beneficial owner" when said recipient's right to use and enjoy the interest is constrained by a contractual or legal obligation (which may result either from a legal document or from the actual behavior of the parties) to pass on the income received to another person.

The Court further confirmed the relevance of the OECD Commentary on Article 11 for the purpose of interpreting the requirement of "beneficial owner" in the context of the IRD.

In its decision, the Italian Supreme Court concluded that a holding company such as LuxCo can be considered as the beneficial owner of the income received from its subsidiary. In this regard, the Court stressed that the analysis should not be performed on the basis of elements and characteristics that might be expected in the case of an operational entity. Instead, whether or not the company has organizational and managerial autonomy, irrespective of a shareholding relationship between companies, must be analysed.

Based on the above, the Italian Supreme Court upheld the decision of the Court of Appeals and considered that LuxCo is to be regarded as the beneficial owner of the interest payments. In particular, the Supreme Court highlighted that:

- the mere fact that LuxCo acted as a sub-holding company and carried out financial and treasury activities did not entail, per se, that it was a conduit company not fulfilling the beneficial ownership requirement;
- LuxCo was not constrained by a contractual or legal obligation to pass on the income received to a third party;
- the net profits derived by LuxCo were adequate, having regard to the specific activity carried out; and
- the loan granted to ItalCo was only one of several loans granted to other group companies in the context of the transaction aimed at acquiring the target companies established in Italy and Sweden.

Furthermore, the Italian Supreme Court made explicit reference to the 2014 version of the OECD Commentary and stated that, even for Italian domestic tax law purposes, the recipient of the income shall not be regarded as the beneficial owner if it does not have the right to use and enjoy the interest unconstrained by a contractual or legal obligation to pass on the payment received to another person. However, such obligation should be dependent on the receipt of the payment by the direct recipient.

4. Conclusion

In its decision, the Italian Supreme Court clarified that a Luxembourg company is to be viewed as the beneficial owner of its income if certain conditions are met.

The importance of this decision cannot be overstated and its conclusions will have an impact which goes way beyond this case, given that many Luxembourg companies invest in Italy. The decision further sheds light on how courts may interpret the guidance of the CJEU in the joined cases (CJEU Decision of February 26, 2019).

Ultimately, the decision of the Italian Supreme Court is very positive as the judges took a reasonable stance on a crucial concept of international taxation. At the very least, it is a contribution to legal certainty in the post-BEPS era.

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