

Tax Treaty Abuse

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Tax Treaty Abuse

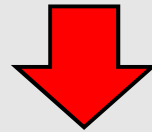
Scope of Tax Treaty

- Purpose of Double Tax Treaty (DTT) (OECD Commentary of art. 1 para. 7):
 - *"The principal purpose of double taxation conventions is to promote, by eliminating international double taxation, exchanges of goods and services, and the movement of capital and persons. **It is also a purpose of tax conventions to prevent tax avoidance and evasion"***

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Improper use of the Treaty

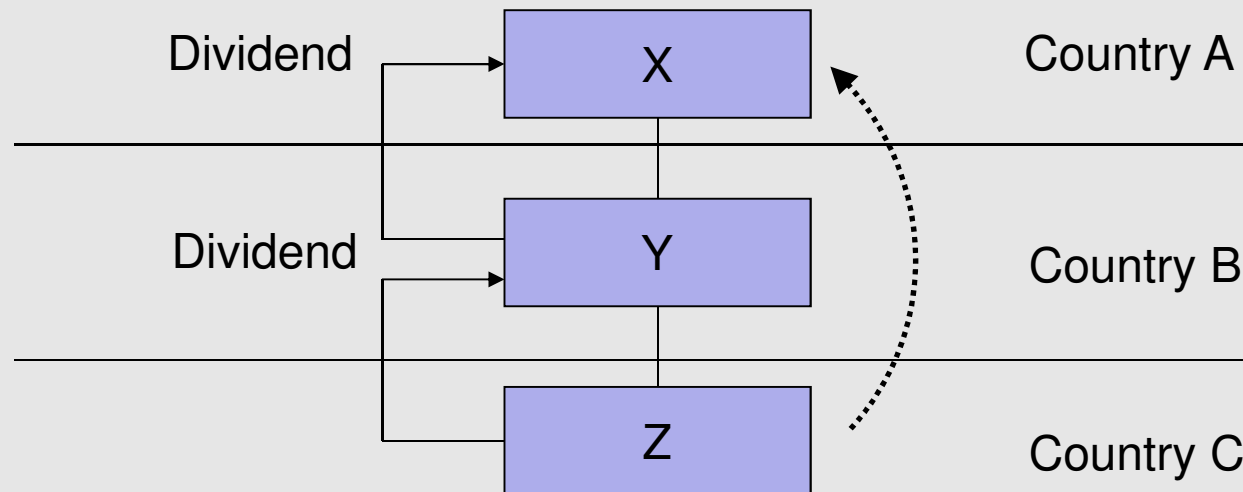
- Eligibility for DTT' benefits (MC OECD Commentary of art. 1 para. 9.4):
 - *"...States do not have to grant the benefits of a double taxation convention where arrangements that constitute an **abuse of the provisions of the convention** have been entered into"*



- Guiding principle (MC OECD Commentary of art. 1 para. 9.5):
 - *"A guiding principle is that the benefits of a double taxation convention should not be available where a **main purpose** for entering into certain transactions or arrangements was to secure a **more favourable tax position** and obtaining that **more favourable treatment** in these circumstances would be contrary to the object and purpose of the relevant provisions"*

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Example of “Treaty shopping”



- Scenario:
 - Dividend distribution from the subsidiary Z to the parent X
 - No treaty between A-C (i.e. the Z domestic WHT of 25% shall apply)
 - The A-B Treaty provides for a 5% WHT
 - X interposes Y to benefit from the B-C treaty which provides for a WHT of 5%
 - Y (no actual activities) turns the dividends to X

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- How to deal with Treaty abuse?
 - “Beneficial Owner” clause
 - Actual owner of the income
 - Anti-abuse rules dealing with source taxation of specific types of income
 - Transaction entered into for the main purpose of obtain specific DTT’ benefits
 - Limitation of benefits clause (LOB)
 - General limitation on treaty benefits

Beneficial owner

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Beneficial Owner (art. 10 OECD MC)

ARTICLE 10 DIVIDENDS

1. *Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State.*
2. *However, dividends paid by a company which is a resident of a Contracting State may also be taxed in that State according to the laws of that State, but if the **beneficial owner** of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed:*
 - a) *5 per cent of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds directly at least 25 per cent of the capital of the company paying the dividends;*
 - b) *15 per cent of the gross amount of the dividends in all other cases.*

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Beneficial Owner (art. 11 OECD MC)

ARTICLE 11 INTEREST

- 1. Interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.*
- 2. However, interest arising in a Contracting State may also be taxed in that State according to the laws of that State, but if the **beneficial owner** of the interest is a resident of the other Contracting State, the tax so charged shall not exceed 10 per cent of the gross amount of the interest. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation*

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Beneficial Owner (art. 12 OECD MC)

ARTICLE 12 ROYALTY

- 1. Royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other State.*
- 2. [...]*
- 3. The provisions of paragraph 1 shall not apply if the **beneficial owner** of the royalties, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties arise through a permanent establishment situated therein and the right or property in respect of which the royalties are paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply.*

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Beneficial Owner - History

- 1977 Commentary to the OECD MC:
 - *“Under paragraph 2 [of Art. 10 (dividends), 11 (interest) and 1 of Art. 12 (royalties)], 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”. (Art. 10, para. 12)*
 - Beneficial ownership as a “**technical requirement**” to get entitlement to the benefits of double taxation conventions

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Beneficial Owner - History

- 2003 Commentary to the OECD MC:
 - *"...The term "beneficial owner" is not used in a narrow technical sense, rather it should be understood in its context and in light of the object and purpose of the Convention, including avoiding double taxation and the prevention of fiscal evasion and avoidance. (Art. 10, para. 12)*
 - *"It would be equally inconsistent with the object and purpose of the Convention for the State of source to grant relief or exemption where a resident of a Contracting State...simply acts as a conduit for another person who in fact receives the benefit of the income concerned. (Art. 10, para. 12.1)*
 - *...a conduit company cannot be normally be 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 parties" (Art. 10, para. 12.1)*

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Beneficial Owner - History

- 2014 Commentary to the OECD MC:
 - *"Where the recipient of a dividend does have the right to use and enjoy the dividend unconstrained by a contractual or a legal obligation to pass on the payment received to another person, the recipient is the "beneficial owner" of that dividend"* (Art. 10, para. 12.4)

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Beneficial Owner – Italian perspective

- No definition of “**beneficial owner**” (BO) under Italian tax law
- Specific definition under Italian legislation implementing EU Directives:
 - Interest and Royalty Directive [Art.26-quater(4) Presidential Decree 29 September 1973 No. 600] : *«if it receives those payments as ultimate beneficiary and not as an intermediary, such as an agent, trustee or authorized signatory, for some other person»*
 - Savings Directive [Art. 1 Legislative Decree 18 April 2005 No. 84]: *«if they receive the payments as ultimate beneficiaries»*

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Beneficial Owner – Italian Treaty practice

- Most treaties signed by Italy contain a beneficial ownership clause in Articles 10, 11 and 12
 - No BO clause is provided in some older DTTs such as those with Cyprus (1974), Egypt (1979), Japan (1969), Hungary (1977), Ireland (1971), Morocco (1972), Thailand (1971), Trinidad and Tobago (1971), Zambia (1972)
- However, only one treaty provides for an autonomous definition of BO:
 - Italy-Germany DTC, § 9 Protocol:
 - the BO is the person
 - entitled to the right the payments derive from; and
 - the income derived therefrom is attributable to under the tax laws of both States

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Beneficial Owner – Italian Interpretation

- Traditionally, Italian tax authorities have interpreted the BO clause in Italian DTCs under a formalistic approach following 1977 Commentary to OECD MC:
 - BO is the person the income is attributed to for tax purposes (Circular 23 December 1996, No. 306; Resolution 6 May 1997, No. 104)
 - A person receiving the income as an agent or nominee or under a fiduciary contract does not qualify as the BO

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Beneficial Owner – Italian Interpretation

- Interpretation of the BO clause provided by the I-R Directives:
 - According to the Tax Authorities (i.e. Circular 47/E of 2005) the BO clause has an anti-abusive purpose and it is met if the recipient of the interest/royalty:
 - Derives an economic benefit from the transaction
 - Has the right to dispose of the income received
 - More recently, in Circular letter 41/E of 2011 the Tax Authorities clarified that the BO clause shall be construed based on:
 - Economic and contractual terms of the transaction
 - Existence of a structure/organization of the recipient
 - Ability to manage/bear financial risks in the hands of the recipient

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Beneficial Owner – Italian Case law

- Definition of BO and substance-over-form approach:
 - Tax Court of first instance of Turin, No. 14, 11.2.2010
 - Facts: royalties paid by an Italian company to a German company entitled to exploitation rights over an IP owned by the US parent company
 - Decision: Treaty benefits were denied lacking any evidence relevant to the right to dispose of the income in the hands of the recipient and the existence of a structure
 - Tax Court of first instance of Turin, No. 124, 19.10.2010
 - Facts: royalties paid by an Italian company to a Luxembourg company controlled by a company resident in Bermuda for the use of a trademark
 - Decision: Treaty benefits were denied based on the absence of effective structure/risk/ activity in the hands of the recipient

Anti-abuse rules dealing with source taxation of specific types of income

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Anti-abuse rules dealing with source taxation of specific types of income

- Denial of benefits relevant to specific DTT's articles (MC OECD Commentary of art. 1 para. 21.4):
 - *"The following provision has the effect of denying the benefits of specific Articles of the convention that restrict source taxation where **transactions have been entered into for the main purpose of obtaining these benefits**. The Articles concerned are 10, 11, 12 and 21; the provision should be slightly modified as indicated below to deal with the specific type of income covered by each of these Articles:*

The provisions of this Article shall not apply if it was the main purpose or one of the main purposes of any person concerned with the creation or assignment of the [Article 10: "shares or other rights"; Article 11: "debt-claim"; Articles 12 and 21: "rights"] in respect of which the [Article 10: "dividend"; Article 11: "interest"; Articles 12 "royalties" and 21: "income"] is paid to take advantage of this Article by means of that creation or assignment.

Limitation of Benefits

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Limitation of benefit clauses (LOB)

- Commonly used in the US Treaty practice
 - As regards Italy, the only Treaty which entails LOB clauses is the ITA-USA Treaty
- The main scope of a LOB clause is to restrict benefits to the intended parties
- To obtain treaty benefits a taxpayer must:
 - Satisfy all requirements specific to the particular benefit
 - Be a “treaty resident” and
 - Meet at least one of the **LOB tests**
- Third country residents are prevented from “treaty shopping”

BEPS Action 6

Tax Treaty abuse

BEPS Action 6

- The OECD released on October 5, 2015 the Final Report on BEPS Action 6 entitled "*Preventing the Granting of Treaty Benefits in Inappropriate Circumstances*"
 - The Report contains model tax treaty provisions and related changes to the model commentary to address the inappropriate granting of treaty benefits and other potential treaty abuse scenarios
- Identification of **treaty abuse**, and in particular treaty shopping, as one of the most important sources of the BEPS project's concerns
 - Strategies through which a person who is not a resident of a State attempts to obtain benefits that a tax treaty concluded by that State grants to residents of that State, for example by establishing a letterbox company in that State
- Implementation of the results into current treaties via a **multilateral instrument**
 - Multilateral convention to implement tax treaty related measures to prevent base erosion and profit shifting (adopted on 24 November 2016)

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BEPS Action 6

- Countries have agreed to include **anti-abuse provisions** in their tax treaties, including a minimum standard to provide a **minimum level of protection** against treaty shopping
- The core recommendations of the report:
 - Change the title/preamble of tax Treaties to make clear that they are not intended to create opportunities for non-taxation through evasion or avoidance
 - Addition of a “limitation on benefits” (“LOB”) article, and
 - Addition of a principal purpose test (“PPT”)
- Also describes tax policy issues to be considered before deciding to enter into a tax treaty

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BEPS Action 6 - Limitation Of Benefits (LOB)

- A LOB rule limits the availability of treaty benefits to entities that are considered "qualified persons"
 - "qualified person" means, among others:
 - individuals resident in a contracting state
 - non-individuals if:
 - 50 percent or more of each class of shares is owned directly or indirectly (on at least half the days in the taxable period) by residents of the contracting state of which the entity is resident and who are themselves entitled to treaty benefits as outlined above; and
 - less than 50 percent of the entity's gross income for the taxable period is paid or accrued to persons who are not residents of either contracting state entitled to the benefits of the treaty on the basis of being qualified persons
 - The qualification of an entity as a "qualified person" seeks to ensure that there is a sufficient link between the entity and its Member State of residence
 - If an entity is not a "qualified person", certain alternative tests apply

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BEPS Action 6 - Principal purpose test (PPT)

- **General anti-abuse rule** based on the principal purposes of transactions or arrangements
- If one of the **principal purposes** of a transaction or arrangement is to **obtain treaty benefits**, these benefits would be denied unless the granting of these benefits is in accordance with the object and purpose of the treaty provision
- In the EU Anti-Tax Avoidance Package, published on January 28, 2016, the European Commission sets out that a PPT has the preference over a LOB provision