Università Carlo Cattaneo – LIUC

International Tax Law a.a.2018/2019

Abuse of Law and Tax Treaty Abuse

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Context:
OECD Model & Bilateral Tax Treaties (DTCs)

Jurisdictions have entered into bilateral tax treaties («DTCs») with the main purpose of avoiding double taxation and promote exchange of goods/services.

Multinational Enterprises (MNEs) may take advantage of benefits available under DTCs and pursue a more efficient tax structure

Legitimate tax planning in order to avoid double taxation

Aggressive tax planning in order to obtain illegitimate tax savings

Treaty abuse/Treaty shopping

Glossary: OECD

The Organisation for Economic Co-operation and Development (OECD)

Our mission www.oecd.org/about/

"The mission of the Organisation for Economic Co-operation and Development (OECD) is to promote policies that will improve the economic and social well-being of people around the world.

*The OECD provides **a forum in which governments can work together to share experiences and seek solutions to common problems**. We work with governments to understand what drives economic, social and environmental change. We measure productivity and global flows of trade and investment. We analyse and compare data to predict future trends. We set international standards on a wide range of things, from agriculture and tax to the safety of chemicals…..".*

- Headquarters in Paris
- 36 member countries (2018) with also some limited key partners (notably BRIC)
- Mostly a "rich country club"

OECD Model Tax Convention – The concept of treaty abuse/treaty shopping

The improper use of DTCs

2014 OECD Model did not make any reference to «treaty abuse».

Reference to the concept of «treaty abuse» could be detected in the 2014 OECD Commentary to art. 1 (concerning the persons covered by the OECD Model), under the paragraph 7, whose title is «Improper use of the Convention».

> *«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****».*

Conventional tax treaty abuse concept is in line with art. 31 of the Vienna Convention on the Law of Treaties («*a treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose”).*

In the new 2017 OECD Model the concept of «treaty abuse» in enclosed in the preamble, as a result of BEPS project.

OECD Model Convention – The concept of treaty abuse/treaty shopping

Glossary: Tax evasion vs. Tax avoidance

General definition of Tax evasion and Tax avoidance (Source: OECD Glossary of Tax terms - http://www.oecd.org/ctp/glossaryoftaxterms.htm#E)

Tax evasion*:* generally used to mean illegal arrangements where liability to tax is hidden or ignored, i.e. the taxpayer pays less tax than he is legally obligated to pay by hiding income or information from the tax authorities.

Tax avoidance*:* generally used to describe the arrangement of a taxpayer's affairs that is intended to reduce his tax liability and that although the arrangement could be strictly legal it is usually in contradiction with the intent of the law it purports to follow.

Preamble of 2017 OECD Model + PPT (Art. 29, par. 9) + LOB (Art. 29)

OECD Model Convention – The concept of treaty abuse/treaty shopping

Definition Treaty abuse/Treaty shopping

Commentary to OECD Model Convention does not include a specific definition about the concept of both «Treaty abuse» and «Treaty shopping». The Commentary gives some principles useful in order to identify the two illegitimate behaviours. Also Preamble to 2017 OECD Model Convention gives some useful indication, as well as the related Commetary to art. 29 (see par. 4)

Based on such principles, tax international doctrine tried to give a definition about these two terms:

- **Treaty abuse**: «*A guiding principle is that 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***» (Source: Commentary on Art. 1 of 2017 OECD Model, paragraph 61)
- **Treaty shopping**: situation for which «*transactions are entered, or entities are established, in other states,* ***solely for the purpose of enjoying the benefit of particular treaty rules*** *existing between the state involved and a third state otherwise would not be applicable*» (Source: Vogel K., On Double Tax Conventions, Kluwer, 1991).

Difference between two concepts is thin. In both situation, the purpose is to avoid the improper use of benefits arising from the DTC application.

OECD Model Convention – The concept of treaty abuse/treaty shopping

Treaty shopping and conduit arrangements

The concept of Treaty shopping is strictly connected to the use of artificial legal constructions in order to benefit from DTC provisions (so called "conduit" position).

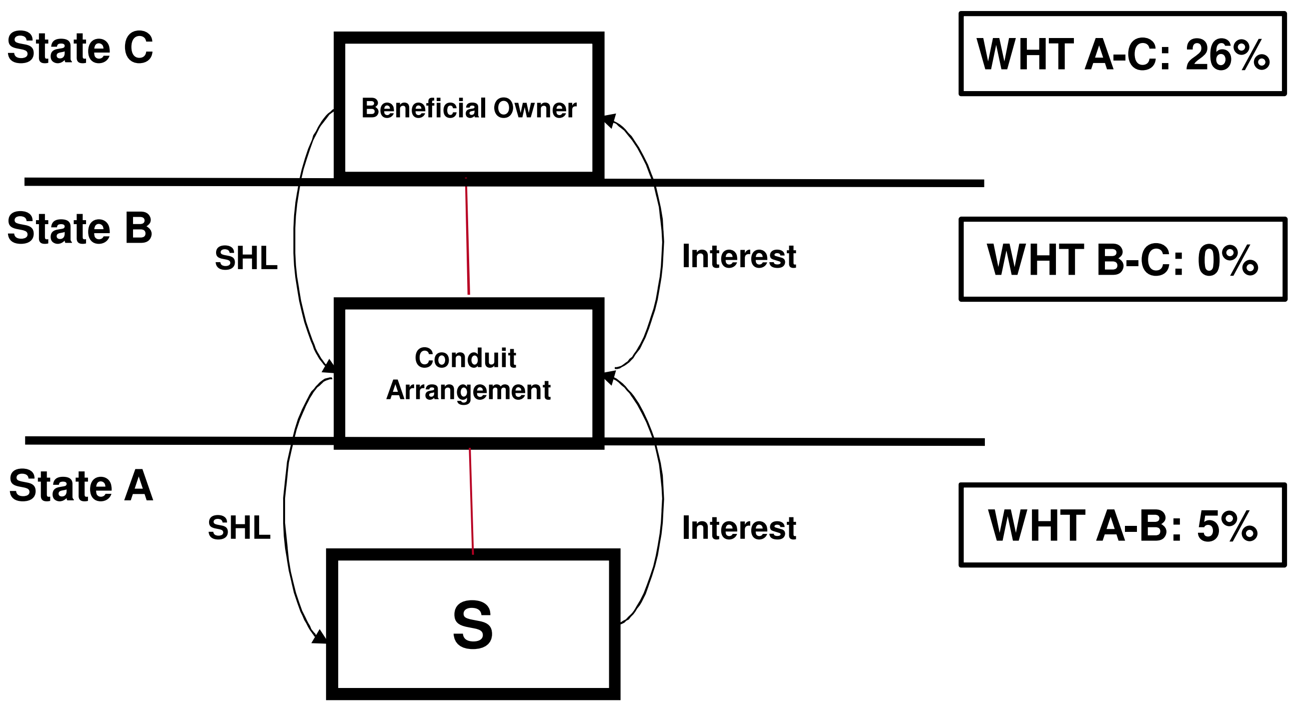
OECD issued in year 1986 a specific report dealing with the matter connected to the use of «conduit» companies in order to benefit from DTC provisions, in order to give some guidelines and propose solutions to be negotiated in bilateral agreements about such improper use of DTC benefits («Double Taxation Conventions and the Use of Conduit Companies» adopted by OECD Council on 27 November 1986). Such conclusions have been then transposed into the OECD Commentary and, in particular, are part of articles/preamble dealing with treaty abuse.

The aim of using **conduit arrangements** is to **obtain treaty benefits not intended by Contracting States** in their bilateral negotiations.

OECD Model Convention – The concept of treaty abuse/treaty shopping

Conduit arrangements and beneficial ownership

Specific treaty shopping situations have been specifically dealt with in the Convention. For instance, reference is made to “beneficial ownership” requirement included in art. 10, 11 and 12 of OECD Model (i.e., payment of dividends, interests and royalties to a resident of the other Contracting state). Commentary to OECD Model gives some guidelines in order outline the concept of “beneficial owner”. However, no consistent definitions of this concept may exist at different levels (see Case Study).



BEPS and MLI – New instruments to prevent tax treaty abuse

Addressing Base Erosion and Profit Shifting «BEPS»

"The integration of national economies and markets has increased substantially in recent years, putting a strain on the international tax rules, which were designed more than a century ago. ***Weaknesses in the current rules create opportunities for base erosion and profit shifting (BEPS)****, requiring bold moves by policy makers to restore confidence in the system and* ***ensure that profits are taxed where economic activities take place and value is created.****"*

BEPS project - In 2013, the OECD published its action plan, which identified 15 separate actions for countering BEPS in a comprehensive and consistent manner. This work culminated in the release of a final package of reports in October 2015 outlining the consensus being reached by participating Countries.

The 2015 final BEPS Reports recommend changes to domestic laws, the OECD Model and the OECD Transfer Pricing Guidelines, along three key pillars:

- Introducing coherence in the domestic rules that effect cross-border activities;
- Reinforcing substance requirements in the existing international standards;
- Improving transparency as well as certainty.

BEPS and MLI – New instruments to prevent tax treaty abuse

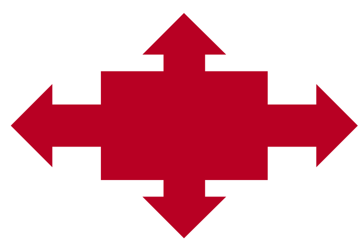
Multilateral Convention To Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting («MLI»)

Full implementation of BEPS measures requires existing double tax treaties to be updated.

MLI was signed on 7 June 2017 by 68 countries in order to directly amend the hundreds of DTCs between those countries in order to introduce new anti-avoidance rules included in BEPS project. Additional countries (16) then signed the MLI instrument (e.g., Ukraine signature occurred on 23 July 2018).

The MLI entered into force for the first five jurisdictions which ratified the agreement (Austria, the Isle of Man, Jersey, Poland and Slovenia) on 1 July 2018. For all other jurisdictions that ratify the agreement, the MLI will enter into force following a period of three months after the date of ratification, at the start of the subsequent calendar month.

- **MLI** does not function in the same way as an amending protocol to an existing bilateral treaty. It does not directly change the underlying text, but **will be applied alongside the existing treaty**, modifying its application. Jurisdictions may prepare consolidated versions of treaties, but there is no requirement to do so.



BEPS and MLI – New instruments to prevent tax treaty abuse

Action 6 of BEPS Project – «*Preventing the granting of Treaty benefits in inappropriate circumstances*»

Action 6 identifies Treaty Abuse, and in particular Treaty Shopping, as one of most important sources of BEPS concerns.

«Taxpayers engaged in treaty shopping and other treaty abuse strategies undermine tax sovereignty by claiming treaty benefits in situations where these benefits were not intended to be granted, thereby depriving countries of tax revenues. Countries have therefore agreed to include anti-abuse provisions in their tax treaties, including a minimum standard to counter treaty shopping. They also agree that some flexibility in the implementation of the minimum standard is required as these provisions need to be adapted to each country's specificities and to circumstances of the negotiation of bilateral conventions.

*These new treaty anti-abuse rules first adress **treaty shopping**, which involves 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 to residents of that State, for example by establishing a letterbox company in that State.»*.

BEPS and MLI – New instruments to prevent tax treaty abuse

Action 6 of BEPS Project – «*Preventing the granting of Treaty benefits in inappropriate circumstances*»

Action 6 recommends the following approach to deal with treaty shopping:

1.First, a clear statement that the **States that enter into a tax treaty intend to avoid creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance**, including through treaty shopping arrangements will be included in tax treaties.

2.Second, **a specific anti-abuse rule, the limitation-on-benefits (LOB) rule, that limits the availability of treaty benefits to entities that meet certain conditions will be included in the OECD Model.** These conditions, which are based on the legal nature, ownership in, and general activities of the entity, seek to ensure that there is a sufficient link between the entity and its State of residence. Such limitation-on-benefits provisions are currently found in treaties concluded by a few countries (such as US tax treaties) and have proven to be effective in preventing many forms of treaty shopping strategies.

3.Third, in order to address other forms of treaty abuse, including treaty shopping situations that would not be covered by the LOB rule above, a more general anti-abuse rule based on the principal purposes of transactions or arrangements (the **principal purposes test or "PPT" rule**) will be included in the OECD Model. Under that rule, **if one of the principal purposes of transactions or arrangements is to obtain treaty benefits, these benefits would be denied unless it is established that granting these benefits would be in accordance with the object and purpose of the provisions of the treaty**.

BEPS and MLI – New instruments to prevent tax treaty abuse

Action 6 of BEPS Project – Minimum standard

Countries have committed to ensure a minimum level of protection against treaty shopping (the “minimum standard”).

Countries will implement this common intention by including in their treaties:

(i) the combined approach of an LOB and PPT rule described above,

(ii) the PPT rule alone, or

(iii) the LOB rule supplemented by a mechanism that would deal with conduit financing arrangements not already dealt with in tax treaties.

Shared approach in order to counteract treaty shopping practices through which companies erod and shift profits in low taxation Countries.

BEPS and MLI – New instruments to prevent tax treaty abuse

<u>Action 6 of BEPS Project– Preamble to be included in Bilateral Tax Treaties «DTCs»</u>

Preamble To The Convention between State (A) and State (B):
"*Desiring to further develop their economic relationship and to enhance their co-operation in tax matters,*
Intending to conclude a Convention for the elimination of double taxation with respect to taxes on income and on capital ***without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance*** *(including through <u>treaty-shopping arrangements</u> aimed at obtaining reliefs provided in this Convention for the indirect benefit of residents of third States),*
Have Agreed as follows:…"

MINIMUM STANDARD - *Such text <u>shall be</u> included in a Covered Tax Agreement in place of or in the absence of preamble language of the Covered Tax agreement referring to an intent to eliminate double taxation, wheter or not that language also refers to the intent not to create opportunities for non-taxation or reduced taxation*

BEPS and MLI – New instruments to prevent tax treaty abuse

<u>Action 6 of BEPS Project – PPT clause (General Anti Abuse Rule «GAAR»)</u>

PPT clause: "*Notwithstanding the other provisions of this Convention, a benefit under this Convention **shall not be granted** in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant <u>facts and circumstances</u>, that **obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit**, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention.*"

MINIMUM STANDARD – *Such paragraph shall apply in place of or in the absence of provisions of a Covered Tax Agreement that deny all or part of the benefits that would otherwise be provided under the Covered Tax Agreement where the principal purpose or one of the principal purposes of any arrangement or transaction, or of any person concerned with an arrangement or transaction, was to obtain those benefits.*

BEPS and MLI – New instruments to prevent tax treaty abuse

Action 6 of BEPS Project – LOB clause (Specific Anti Abuse Rule «SAAR»)

Limitation on benefit ("LOB") clause: rules aimed to identify through certain categorical tests the "qualified person" which can benefit for the provision of bilateral tax treaty.
Action 6 provides for a simplified LOB and a detailed one (elements of this latter to be negotiated by jurisdictions).

Parties are allowed to supplement the PPT (which reprensents the minimum standard) by electing to also apply the simplified LOB.

Briefly, jurisdictions have the following options:

- Option 1: PPT only (Italy choice);
- Option 2: PPT and simplified LOB;
- Option 3: detailed LOB rule (to be negotiated by States). In such a case jurisdiction can make reservations on PPT rule.

BEPS and MLI – New instruments to prevent tax treaty abuse

<u>Action 6 of BEPS Project and Article 7 of MLI – Recap of previous concepts</u>

Article 7 of MLI
«Prevention of treaty abuse»

Minimum standard but three options

a) Principle Purpose Test (PPT) only

b) Simplified Limitation on Benefit (LOB) + PPT

Asymmetry possible

c) Detailed Limitation on Benefit (LOB)

No text in Convention
↓
Commitment to bilateral Negotiation

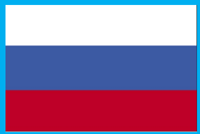
Must include anti-conduit rules

OECD Matching database - ***<u>http://www.oecd.org/tax/treaties/mli-matching-database.htm</u>***

BEPS and MLI – New instruments to prevent tax treaty abuse

Action 6 of BEPS Project (Article 7 MLI):

Illustrative examples of the Matching Exercise

	The Netherlands: PPT only 	**United Kingdom:** PPT only 
Outcome:	PPT	PPT
	Russia: Simplified LOB + PPT 	**Cyprus:** PPT only 
Outcome:	PPT	PPT

BEPS and MLI – New instruments to prevent tax treaty abuse

Action 6 of BEPS Project – Relationship with domestic anti-abuse legislations

The report recognizes that the adoption of anti-abuse rules in tax treaties is not sufficient to address tax avoidance strategies that seek to circumvent provisions of domestic tax laws; these must be addressed through domestic anti-abuse rules, including through rules that will result from the work on other parts of the Action Plan.

Tax treaty override – Domestic tax laws vs. tax Conventional legislation

Tax treaty override - definition

Tax treaty override originates from a conflict between international treaty provisions and national law provisions which are considered to be prevailing under the relevant State's legislation.

The 1989 OECD Report on tax treaty override states that: "*The term "treaty override" refers to a situation where the domestic legislation of a state overrules provisions of either a single treaty or all treaties hitherto having had effect in that State.* ***Legislation may take the form of a provision that treaty provisions are to be disregarded in certain circumstances (e.g. in cases of treaty shopping or other forms of abuse).***
Legislation can also have the effect of overriding treaties, even where no reference is made in the legislation to treaty provisions as such, because the domestic interpretation of the effect of that legislation in relation to treaty provisions has the same effect in practice."

- *Breach of Art. 26 and Art. 27 of* Vienna Convention on the Law of Treaties *(pacta sunt servanda).* State cannot justify breach of treaty on the basis of national law.

Tax treaty override – Domestic tax laws vs. tax Conventional legislation

When Tax Treaty override may occur:

- In those States in which international law becomes a law of the State and it ranks equal to national law. Such States may consider international legislation as amended because of subsequent national provisions (*lex posterior abrogat priori*).
- A contracting State changes a definition in its domestic tax law and, as a consequence, the new definition causes the application of a "distributive rule" under a Tax Treaty which would not be applicable on the basis of the very nature of the item of income/capital.
- Domestic anti-abuse legislation is adopted or applied in conflict with tax treaty provisions.

- *How to deal with Tax Treaty Override? It is very difficult to protect taxpayers' interest in those States which allow the unilater amendment of Tax Treaty rules.*

Tax treaty override – Domestic tax laws vs. tax Conventional legislation

Tax treaty override – Domestic and Conventional anti avoidance rules according to OECD

Commentary on art. 1 of OECD Model Convention of 2017 includes comments on the relantionship between domestic and conventional anti abuse rules:

- The OECD Commentary allows States to qualify Treaty Abuse according to their domestic legislation. This is based on the alleged absence of conflicts between domestic and Conventional tax avoidance rules;

- In case of conflict, the provisions of tax treaties are intended to prevail (*pacta sunt servanda*).

- *Notwithstanding OECD Commentary's position, Tax Treaty Override takes place any time States apply national anti-abuse provisions which are in conflict with existing tax treaties.*

Tax treaty override – Domestic tax laws vs. tax Conventional legislation

<u>Tax treaties override – Rules applicable in Italy</u>

No tax treaty override should occur in Italy due to Constitutional/Legislative framework:

- Art. 117, Par. (1) of the Italian Constitution: legislative power (both central and regional) is limited by international treaty obligations;
- Art. 75 of Presidential Decree N. 600/1973 states that tax treaty provisions prevail over domestic tax legislation;
- Art. 169 of Presidential Decree N. 917/1986 (Italian Income Tax Code): domestic tax rules prevail over tax treaty provisions if those are more favorable to taxpayers.

EU environment – Anti-abuse measures

ATAD (Anti Tax Avoidance Directive)

Proposal of a Council Directive laying down rules against tax avoidance practices that directly affect the functioning of the internal market (2016) – ***Main purpose is the fight against tax avoidance and aggressive tax planning at European Union (EU) levels that affects the functioning of the internal market, in order to ensure that taxes are paid where value and profits are generated***

- *The Proposal responds to the finalisation of the project against Base Erosion and Profit Shifting (BEPS) by the G20 and the OECD as well as to demands from the European Parliament, several Member States, businesses and civil society, and certain international partners for a* ***stronger and more coherent EU approach against corporate tax abuse***

EU environment – Anti-abuse measures

<u>ATAD (Anti Tax Avoidance Directive)</u>

The BEPs project represents the reference point to for the elaboration of anti-abuse rules at EU level (need for fairer taxation within the EU environment). In OECD context, the unilateral and divergent implementation of BEPS by each Member State could fragment the Single Market by creating national policy clashes, distortions and tax obstacles for businesses in the EU. It could also create new loopholes and mismatches that could be exploited by companies seeking to avoid taxation, thereby undermining Member States' efforts to prevent such practices. It is therefore essential for the good functioning of the Single Market that Member States – as a minimum - transpose the OECD BEPS measures into their national systems **<u>in a coherent and coordinated fashion.</u>**

- *The Directive aims to achieve a balance between the need for a certain degree of uniformity in implementing the BEPS outputs across the EU and Member States' needs to accommodate the special features of their tax systems within these new rules. The text thus lays down principle-based rules and leaves the details of their implementation to Member States, on the understanding that they are better placed to shape the precise elements of the rules in a way that best fits their corporate tax systems.* ***<u>As such, the Directive should create a level-playing field of minimum protection for all Member States' corporate tax systems.</u>***

EU environment – Anti-abuse measures

ATAD (Anti Tax Avoidance Directive)

The OECD and other EU institutions have flagged the following potential additional measures which could help address aggressive tax planning:

- Limiting interest deductions, one of the principal instruments for profit shifting;
- Eliminating negative impacts of hybrid mismatches, so they do not result in double non taxation;
- Strengthening controlled foreign company rules (CFC), which ensure that profits parked in low or no tax countries are effectively taxed;
- Reinforcing rules relating to how assets are taxed when they are transferred to another state (exit taxation);
- Introducing an EU wide General Anti Abuse Rule (“GAAR”).

EU environment – Anti-abuse measures

ATAD (Anti Tax Avoidance Directive)

States must implement the measures in their national legislation by 31 December 2018. The measures must become effective as of 1 January 2019. The rules regarding exit taxation must be implemented by 31 December 2019 and must become effective as of 1 January 2020. Since the ATAD introduces only minimum measures, Member States remain free to adopt additional or more stringent versions of the anti-tax avoidance rules.

Italian Government approved few days ago the Legislative Decree implementing the ATAD measures. Such rules will enter into force when published in official Gazete.

EU environment – Anti-abuse measures

Mandatory Disclosure Directive

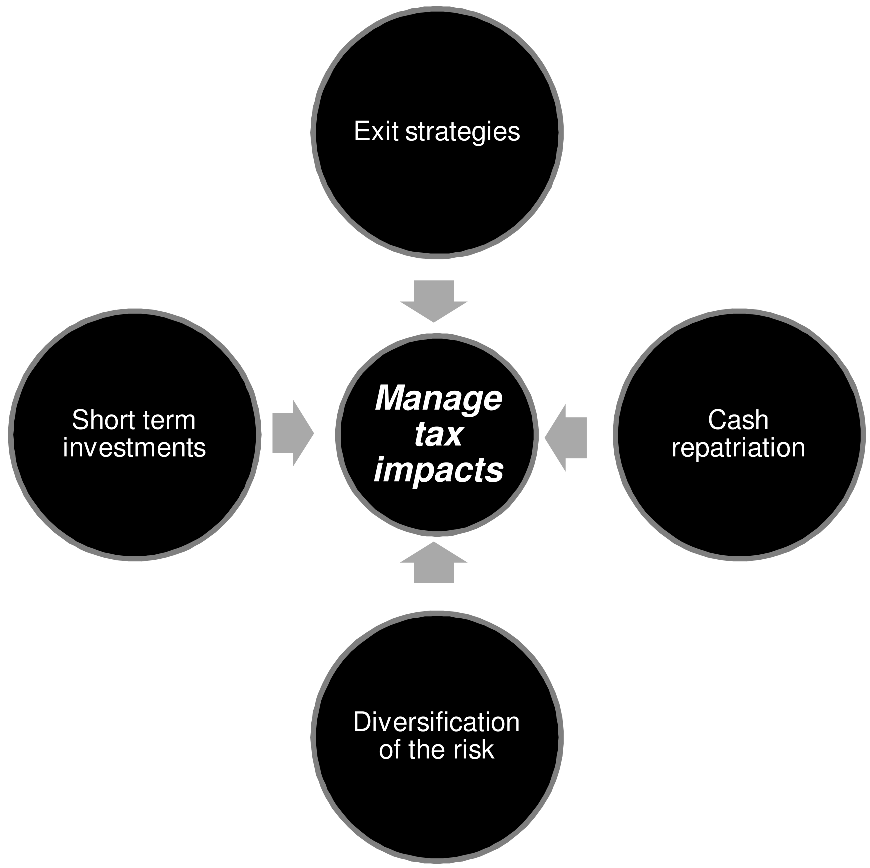
On 25 May 2018, the Council of the European Union formally adopted new mandatory disclosure rules (MDRs) for qualifying intermediaries and relevant taxpayers. As of 1 July 2020, intermediaries or in some cases, taxpayers, will be required to disclose to their tax authorities information on reportable cross-border arrangements. Member States shall adopt and publish, by 31 December 2019 at the latest, the laws, regulations and administrative provisions necessary to comply with this Directive. They shall apply those provisions from 1 July 2020.

- "*The Commission has been called on to embark on initiatives on the mandatory disclosure of information on potentially aggressive tax-planning arrangements along the lines of Action 12 of the OECD Base Erosion and Profit Shifting (BEPS) Project. In this context, the European Parliament has called for tougher measures against intermediaries who assist* ***in arrangements that may lead to tax avoidance and evasion****.*"

Case Study – Investments made by PE funds and concept of beneficial owner

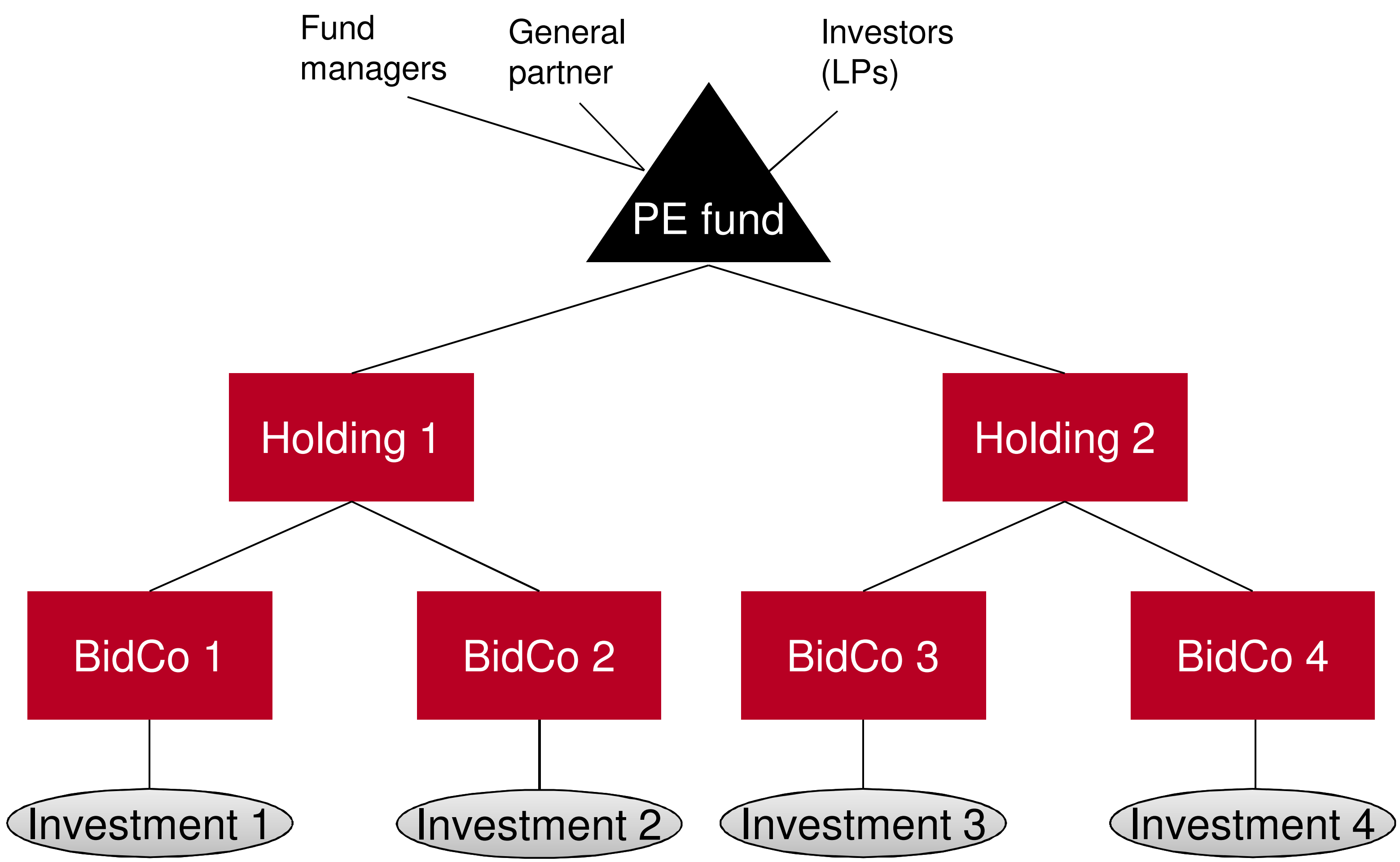
Private equity (PE) funds

Private equity fund (PE fund): collective investment scheme used for making investments (*inter alia*) in equity of companies operating in different businesses.



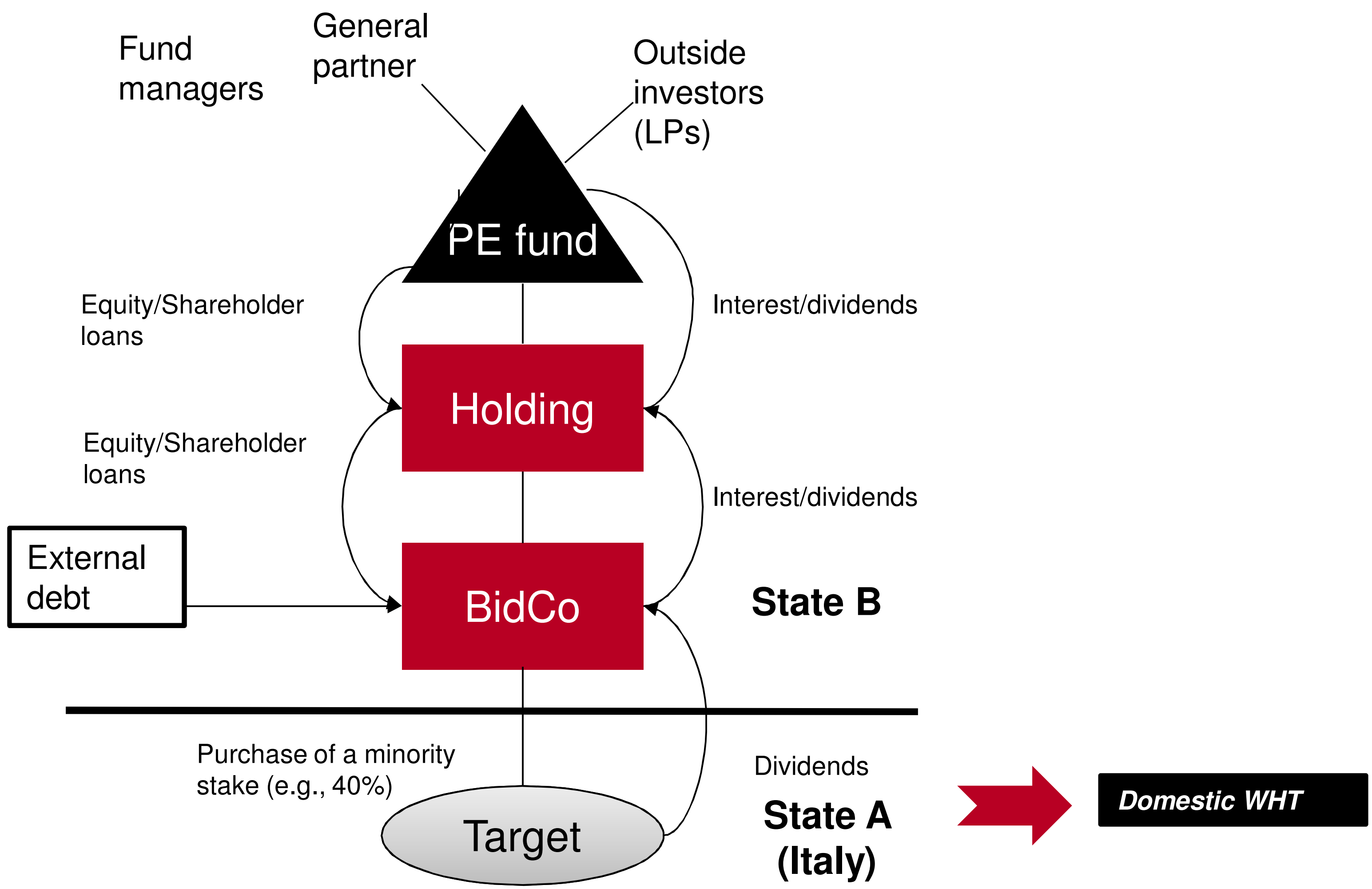
Case Study – Investments made by PE funds and concept of beneficial owner

Structure of PE funds



Case Study – Investments made by PE funds and concept of beneficial owner

<u>Investments of PE funds – Cash extraction and tax implications</u>



Case Study – Investments made by PE funds and concept of beneficial owner

Cash extraction and beneficial owner («BO») requirement

In general, tax matters related to cash repatriation from Target are the following:

1) Domestic WHT to be applied on dividend payments from Target to BidCo;
2) Domestic taxation of capital gain arising from the disposal of Target.

In principle, PE funds are not eligible:

- For the application of Parent-Subsidiary (PS) Directive, as implemented in Italy by art. 27-bis in relation to WHT exemption for dividend payments to non-resident entities;
- For the application of benefits provided by DTC (art. 10), in relation to WHT rate reduction for dividend payments to non-resident entities;
- For the application ot benefits provided by DTC (art. 13), in relation to exclusive taxation in the Country of Residence for the capital gain arising from the disposal of the investment.

Efficient cash repatriation is one of the goals of PE Fund managers

Case Study – Investments made by PE funds and concept of beneficial owner

<u>Cash extraction and beneficial owner («BO») requirement</u>

PE funds incorporate intermediate holding companies in order to segregate the risk for each investment made.

Holding companies are generally incorporated in Countries which have a large number of bilateral tax treaties with other jurisdictions.

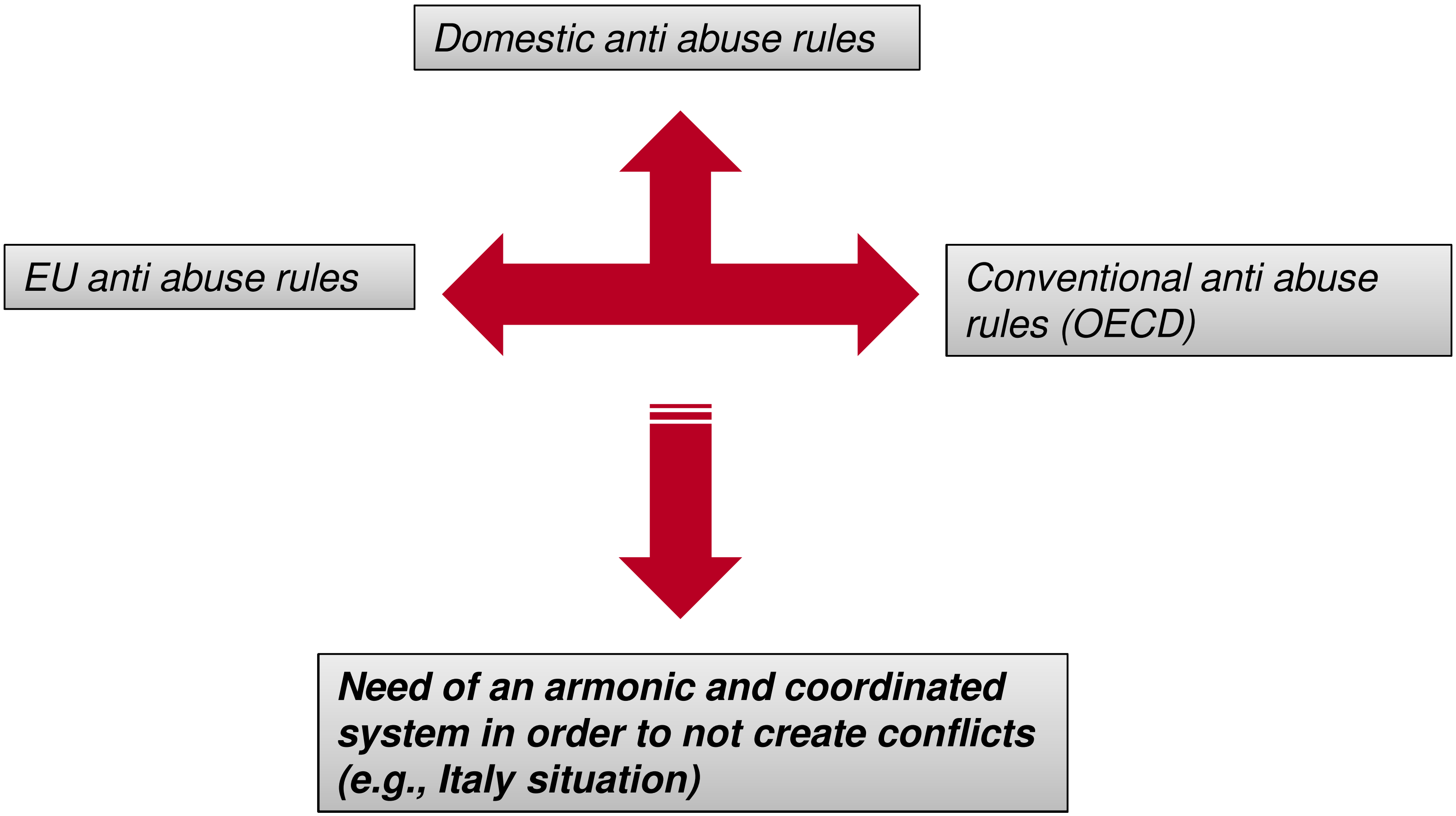
In order to benefit for WHT reduction/exemption, the intermediate holding company has to be the <u>actual Beneficial Owner</u> of dividend payments.

It is not easy to demonstrate the beneficial ownership requirement for holding companies incorporated by PE funds, considering that:

- it is difficult to prove that «pure» holding companies carry out a business activity (they merely own and manage the participations into the operating entities);
- they have a «light» hard substance in terms of employees and offices;
- due to the cash repatriation process up to the PE funds investors, it is difficult to prove the economical ownership of the income arising from the investments.

Case Study – Investments made by PE funds and concept of beneficial owner

Abuse of tax law (BO) – Domestic, Conventional and EU rules



Case Study – Investments made by PE funds and concept of beneficial owner

<u>Parent-Subsidiary Directive – GAAR</u>

Italian domestic law is in line with the general anti-abuse clause ("GAAR") provided by the amended EU Parent-Subsidiary Directive 2015/121 dated 27 January 2015.

The GAAR refers to dividends distributed *"within an **arrangement** or a series of arrangement which, having been **put into place for the main purpose, or one of the main purposes, of obtaining a tax advantage** contrary to the object or purpose of the participation exemption regime, **are not genuine** having regard to all relevant facts and circumstances"* (i.e., "not put into place for valid commercial reasons which reflect economic reality").

No reference to Beneficial Ownership Concept

Case Study – Investments made by PE funds and concept of beneficial owner

OECD Model interpretation (Commentary on art. 10)

”*The term “beneficial owner” […] was intended to be interpreted in this context and not to refer to any technical meaning that it could have had under the domestic law of a specific country (in fact, when it was added to the paragraph, the term did not have a precise meaning in the law of many countries). The term beneficial owner […] should be understood in its context, and in light of the object and purposes of the Convention, including avoiding double taxation and the prevention of fiscal evasion and avoidance.*
Where an item of income is paid to a resident of a Contracting State ***acting in the capacity of agent or nominee*** *it would be inconsistent with the object and purpose of the Convention for the State of source to grant relief or exemption merely on account of the status of the direct recipient of the income as a resident of the other Contracting State.*

[…]

”*In these various examples (agent, nominee, conduit company acting as a fiduciary or administrator), the direct recipient of the dividend is not the “beneficial owner” because* ***that recipient's right to use and enjoy the dividend is constrained by a contractual or legal obligation to pass on the payment received to another person****. Such an obligation will normally derive from relevant legal documents* ***but may also be found to exist on the basis of facts and circumstances showing that, in substance, the recipient clearly does not have the right to use and enjoy the dividend unconstrained by a contractual or legal obligation to pass on the payment received to another person”****.*

Case Study – Investments made by PE funds and concept of beneficial owner

Italian Tax Authorities interpretation (Circular Letter n. 6/E of 30 March 2016)

The intermediary holding companies which PE funds set up must have an actual connection with the economic system of their country of establishment and cannot be mere "conduit," i.e. an entity that does not carry out any real business activity with reference to the specific transaction.

The circular letter confirms that the holding companies are not eligible for PS Directive/Tax Treaty benefits if the intermediate holding company:

- Has a "light structure" (e.g. when the employees, office space and equipment are provided by a "domiciliary company" through a management service agreement), lacking real business activities and actual (i.e. not only formal) decision-making power (e.g. on the management of the investment) – **"conduit entity/arrangement"**; **OR**
- Is a mere conduit structure with reference to the specific transaction, in a substantial back-to-back position (the same contractual terms in relation to maturity, amounts, etc.) – **"conduit transaction".**

Case Study – Investments made by PE funds and concept of beneficial owner

<u>Strictly legal vs a broad economic approach</u>

Italian tax Authorities approach – often they challenge the lack of what they call the "economical" beneficial owner status of the recipient - which goes beyond the legal beneficial ownership of the income - notwithstanding the presence of hard substance elements (e.g. office spaces, employees, utilities bills, active bank accounts) and sounding business reasons (such as presence of multiple investments, effective controllership role over the assets, etc.). **Broad Economic approach**

In tax authorities' view, the foreign recipient should be able to demonstrate its **full autonomy in managing the financial flows related to the assets generating the income (no pass-through approach towards other entities)** and taking management decision about the related assets, which it is sometimes very difficult in a multinational group context, <u>and maybe impossible in respect of investments made by PE funds</u>.

In recent case law (e.g., Supreme Court N. 10792/ 2016; Supreme Court N. 27113/2016) the **legal approach** has been put forward, also in line with latest clarification under OECD framework). It follows that the beneficial ownership requirement is fulfilled if the person entitled to receive the income (i.e. the beneficial owner):

- is not only legally entitled to that item of income or is attributed that item of income under income tax law, but also has the item of income concretely available to him (i.e. has the power to decide how to use and enjoy it);
- is entirely autonomous in respect of the economic activity from which the item of income is derived because he has an appropriate level of organization and he has assumed the relevant entrepreneurial risks;
- has not very narrow powers which render him, in relation to the income concerned, a mere fiduciary or administrator acting on account of the interested parties;
- has not the obligation to pass on the payments to other persons.

Case Study – Investments made by PE funds and concept of beneficial owner

<u>Cash extraction and beneficial owner («BO») requirement</u>

Uncertainty to investors in relation to beneficial ownership concept/ non genuine arrangements concept under Conventional, Domestic and EU rules.

Having regard to PE acquisition structures under discussion, there is no checklist which can be used in order to assess compliance with BO requirements.

> Italian Tax Authorities provided in their Circular letters certain elements in order to prove the genuinity of the structure (i.e, to prove that no conduit arrangement/position exist). Such elements usually cannot all be identified at the level of a «pure» holding company. Recently, a decision of Supreme Tax Court provided that «pure» holding companies cannot be *tout court* considered lacking of beneficial ownership requirement.

As such, multiple elements are helpful to support BO requirement at the level of intermediate holding entities owned by PE funds.

- Different interpretations (no shared definition)
- Broadly, two contrasting interpretations exist; a strictly legal vs a broad economic approach.