

LIUC – Università Carlo Cattaneo

International Tax Law

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*Parent-Subsidiary Directive, Interest-
Royalties Directive and beneficial
ownership*

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Parent-Subsidiary Directive

The Directive in general

- Common regime of dividend flows within the European Union
- Rationale: avoid double taxation on dividend flows within Member States
- Directive 2011/96/EU has recast and updated Directive 90/435/EEC
- State of the Subsidiary
 - Exemption in the State of the subsidiary company
- State of the Parent
 - Exemption or underlying tax credit in the State of the parent company
- Special rules for PEs and transparent entities

Personal scope

“Company of a Member State” (Article 2(a))

- Legal form
- Residence
- Subject to tax

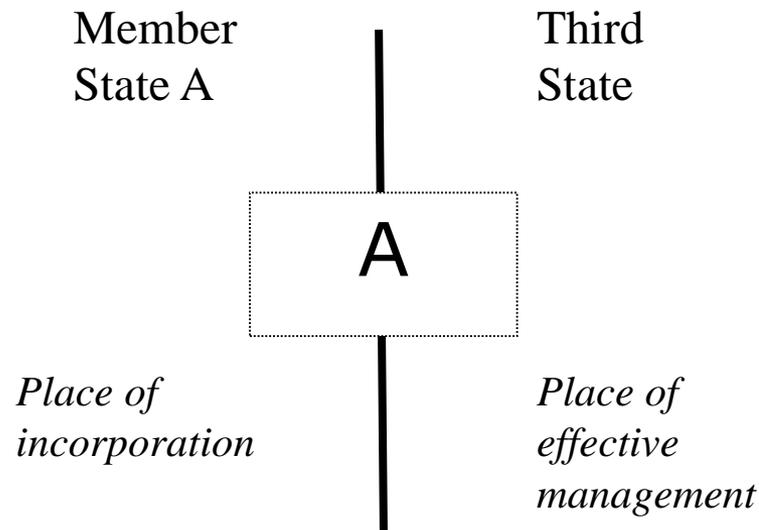
Legal form

- The company shall take one of the forms listed in Annex I, Part A (Article 2 (a)(i))
- The list of Annex I, part A shall be considered closed (CJEU, C-247/08, *Gaz de France*) but Member States cannot discriminate

Residence

Art. 2(a)(ii):

- The company shall be considered resident for tax purposes of a Member State; and
- Shall not be considered resident only in a third State according to the tie breaker rule of the double tax treaty between the member State of residence and the third State



Subject to tax

Article 2(a)(iii)

- The company shall be subject to one of the taxes listed in Annex I, Part B, without the possibility of an option or of being exempt.
 - A company liable to tax but subject to tax at zero rate cannot benefit from the Directive because it cannot be considered subject to tax (*Wereldhave* (C-448/15))

P-S Relationship

The participation threshold

- At least 25% of the capital (1990-2005)
- 20%, as from 2005
- 15%, as from 2007
- **10%, as from 2009**

- More in line with conditions for domestic dividend exemptions

- Criterion of capital may be replaced by voting rights through bilateral agreements

- Usufruct does not allow to meet the requirement of “holding in the capital” (CJEU, Case C-48/07, *Les Vergers du Vieux Tauves*)

P-S relationship

Holding period

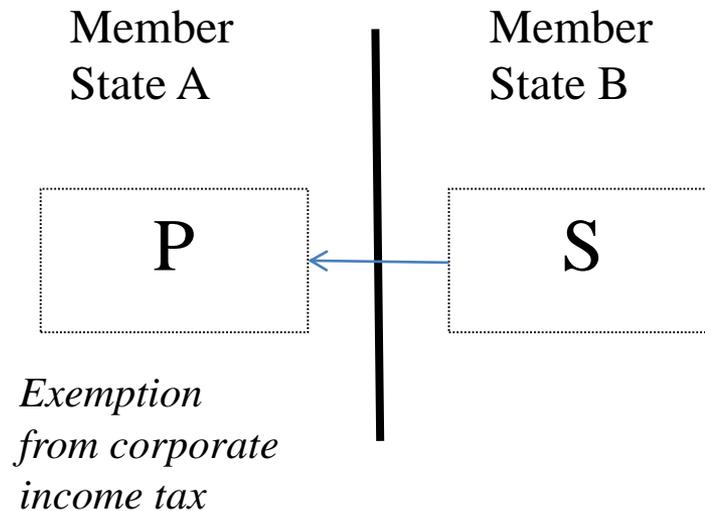
- Optional holding period
- No more than 2 years
- It may be met after the distribution
 - ECJ Case C-283/94 Denkavit
 - Italian tax authority in Letter ruling 109/E 2005
- Belgian ruling no. 2010.216 of 15 June 2010
 - Where dividends are paid before the expiry of the holding period, a guarantee equal to the wht not levied must be provided
- Similar statement by the Greek TA on 5/8/2015

Exemption or imputation credit

- Article 4: the Member State of residence of the parent company shall either:
 - a) Exempt the dividends received by the parent; or
 - b) Grant the parent company a credit for the corporate tax suffered by the subsidiary

Exemption

- Article 4: the Member State of the parent company shall exempt the dividends

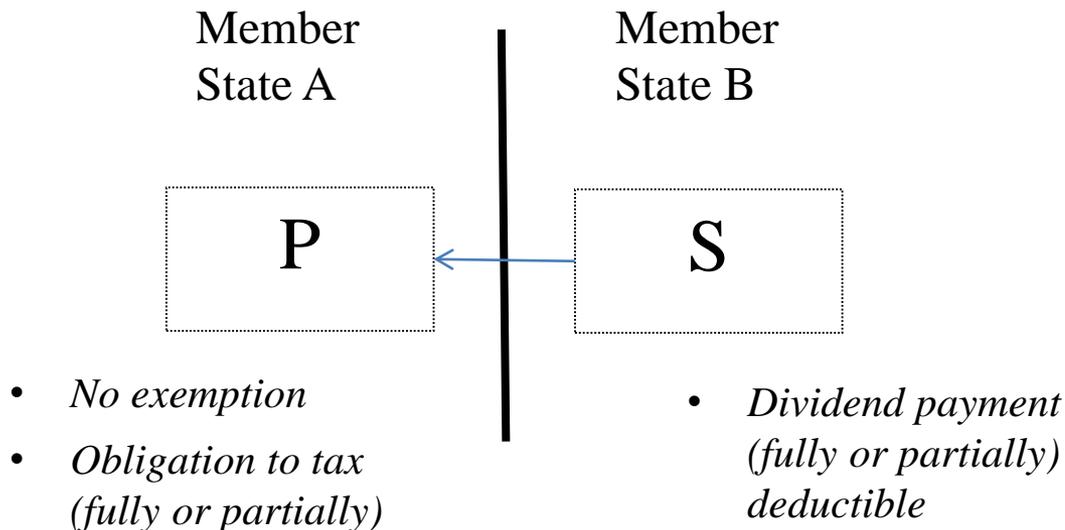


Hybrid mismatches

- Directive 2014/86/EU limited the exemption provided by Art. 4 of P-S Directive.
- Original proposal by the Commission – Change to Art. 4(1)(a):
 - “*...refrain from taxing such profits to the extent that such profits are not deductible by the subsidiary of the parent company*”
- Approved text - Change to Art. 4(1)(a):
 - “*...refrain from taxing such profits to the extent that such profits are not deductible by the subsidiary, and tax such profits to the extent that such profits are deductible by the subsidiary*”

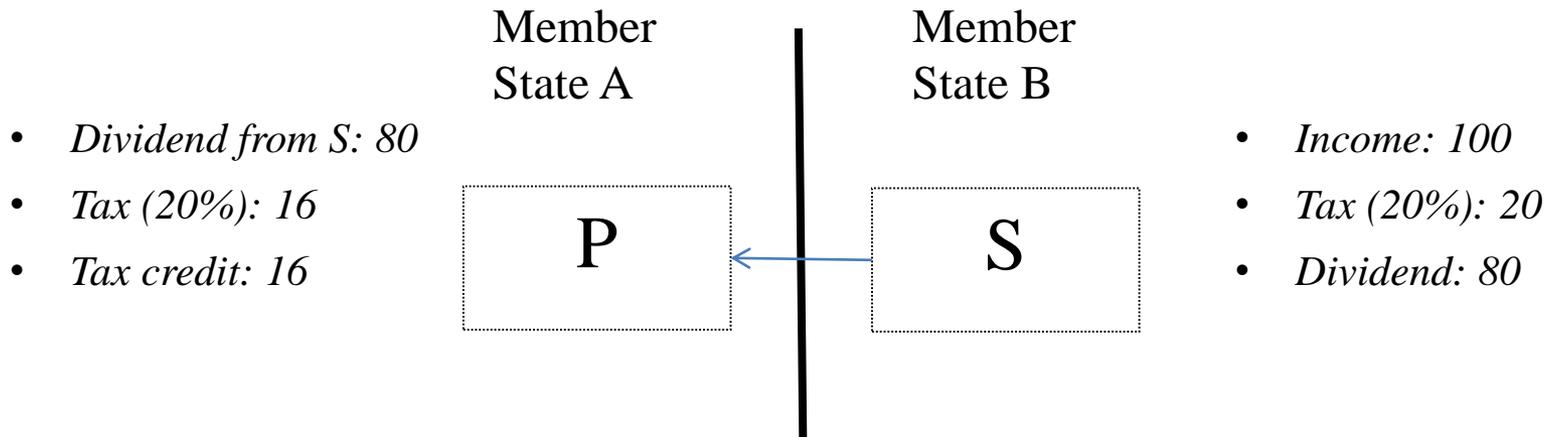
Hybrid mismatches

- If the payment is deductible in the Member State of the subsidiary, the Member State of the parent shall not grant any exemption and shall tax the payment.



Imputation system of further tier-subsubsidiaries

- Article 4 (1)(b)



- Credit to be granted also in respect of further-tier subsidiaries provided that at each level the companies qualify as parent and subsidiary company

Exemption system and further tier-subsubsidiaries

Member
State A



Exemption

- *Dividend from B: 80*
- *Tax: 0*
- *Dividend after tax: 80*

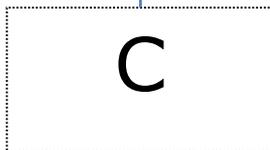
Member
State B



Exemption

- *Dividend from C: 80*
- *Tax: 0*
- *Dividend after tax: 80*

Member
State C



- *Income: 100*
- *Tax (20%): 20*
- *Dividend: 80*

Imputation system and further tier-subsubsidiaries

Member
State A



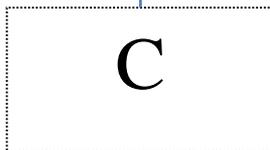
Imputation

Member
State B



Exemption

Member
State C



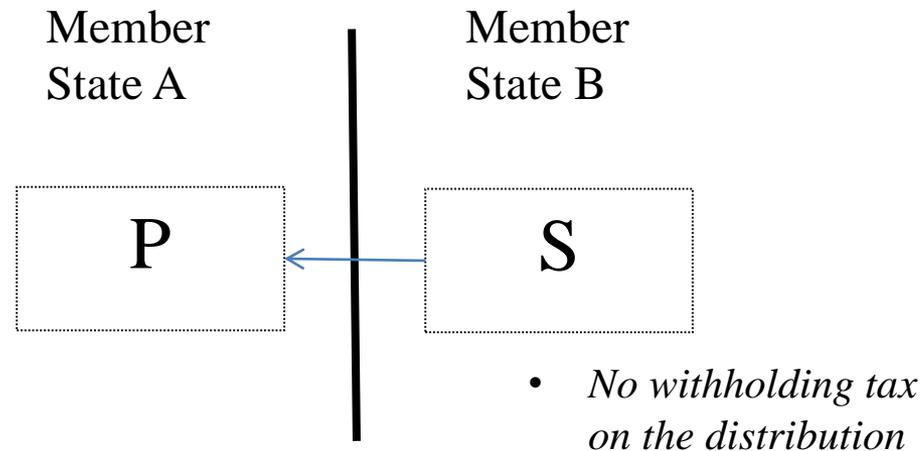
- *Dividend from B: 80*
- *Tax (20%): 16*
- *Credit for tax paid in C: 16*
- *Dividend after tax: 80*

- *Dividend from C: 80*
- *Tax: 0*
- *Dividend after tax: 80*

- *Income: 100*
- *Tax (20%): 20*
- *Dividend: 80*

Definition of WHT

- *Art. 5: “Profits which a subsidiary distributes to its parent company shall be exempt from withholding tax”*



- No explicit definition of “withholding tax”

Definition of WHT

- Explicit exclusion under Art. 7(1): *“The term «withholding tax» as used in this Directive shall not cover an advance payment or prepayment (précompte) of corporation tax to the Member State of the subsidiary which is made in connection with a distribution of profits to its parent company”*.
- Art. 7(2): *“This Directive shall not affect the application of domestic or agreement-based provisions designed to eliminate or lessen economic double taxation of dividends, in particular provisions relating to the payment of tax credits to the recipients of the dividends”*.

Definition of WHT

- Case law of CJEU (see *C-68/15, X*): three criteria:
 1. the tax must be levied in the State in which the dividends are distributed and its chargeable event must be the payment of dividends or of any other income from shares;
 2. the taxable amount is the income from those shares;
 3. the taxable person is the holder of the shares.

Definition of WHT

- Case C-375/98 – *EPSON*:
 - Portugal: 5% substitute tax of inheritance and gift tax upon the payment of dividends
 - CJEU:
 - Substitute tax has the same effect of WHT
 - National qualification irrelevant

Scope of the Directive

Original anti-abuse provision

- The original Directive of 1990 (Directive 90/435/EEC) contained a provision allowing Member States to deny the directive benefits in application of their anti-abuse provision (current Article 1(4))
- Some Member States (*e.g.*, Italy, France) **automatically** denied the Directive benefits if the parent company was controlled by a non-EU company unless the taxpayer could prove that the structure was not abusive
- The CJEU (Case C-6/16, *Eqiom*) concluded that such automatic presumption was contrary to the Directive and to the freedom of establishment

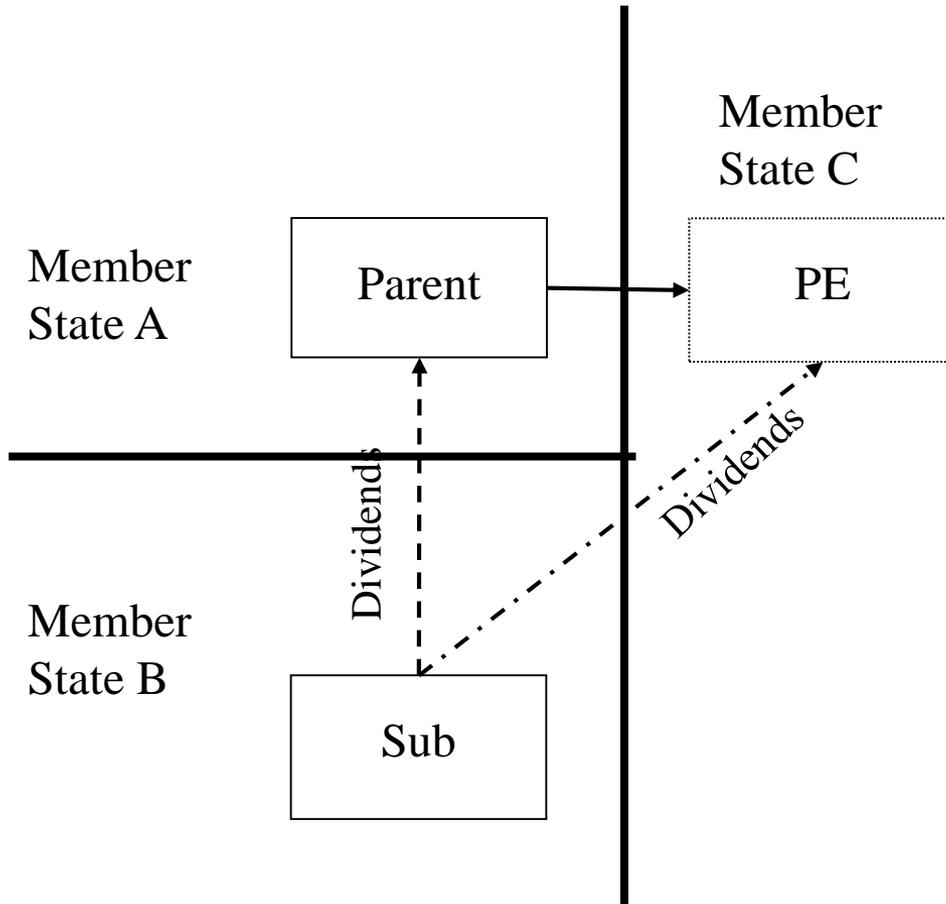
New (additional) anti-abuse clause

- In 2015 the Directive was modified to introduce a General Anti-Avoidance Rule (GAAR) that Member States are obliged to implement
- Provision similar to the many Member States GAAR (*e.g.*, Italy):
 - Benefits of the Directive to be denied if:
 - Obtained through an arrangement or series of arrangements;
 - Whose main purpose or one of the main purposes was to obtain an advantage contrary to the *ratio* of the Directive;
 - Not put in place for valid commercial reasons which reflect economic reality

The application to PEs

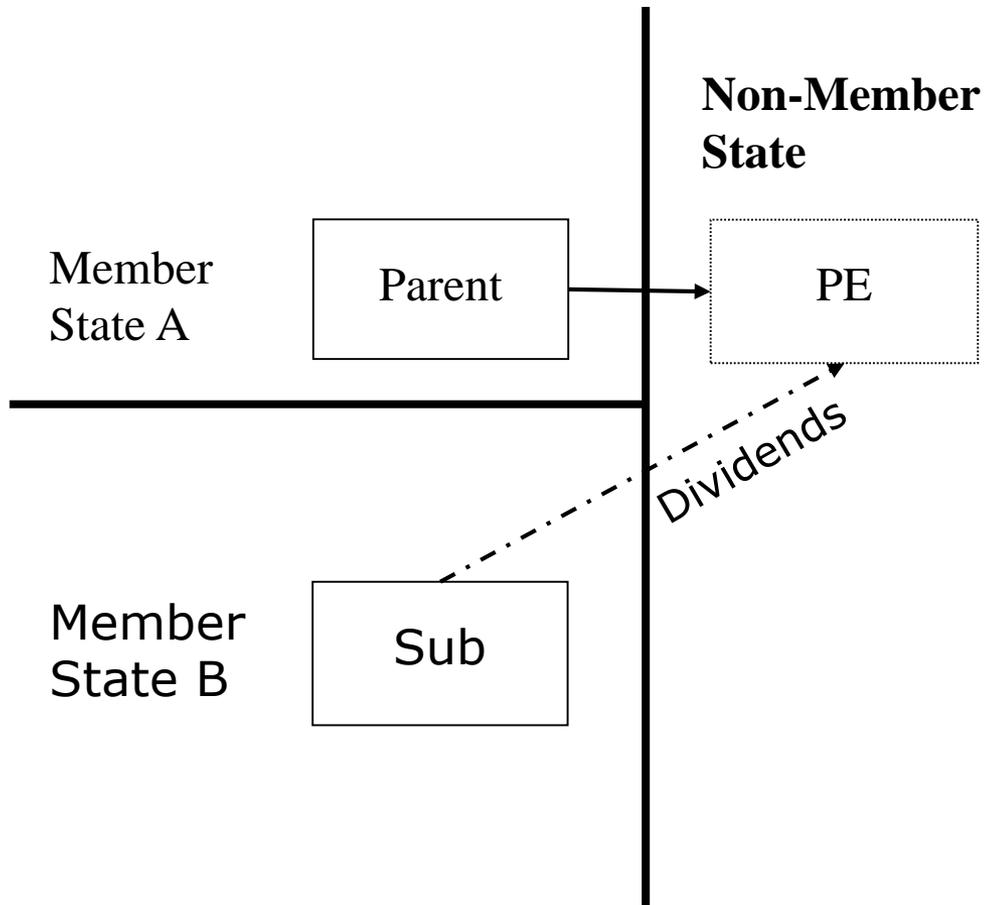
- In 2003 the scope of the Directive was widened in order to cover dividend payments received by permanent establishments (PE)
- Directive applicable only to PE located in Member States of companies of Member States
- Explicit definition of PE
 - Solely a fixed place of business; no “agency” PE
 - PE’s profits must be “subject to tax” in the State in which the PE is situated by virtue of treaty or domestic law

The application to PEs



- Parent holds 30% of Sub (of which 5% through PE)
- The Directive applies on the dividends between sub and PE (relevance to the shares held by the parent)
- Member State C shall exempt the dividends received by the PE
- Member State A shall exempt the dividends
- Member State B shall not levy any withholding tax

The application to PEs



- The Non-Member State is not bound by the Directive
- Member State A shall exempt the dividends
- Member State B shall not levy any withholding tax

Interest & Royalties Directive

The Directive in general

- Council Directive 2003/49/EC of 3 June 2003
- As amended by:
 - Council Directive 2004/66/EC
 - Council Directive 2004/76/EC
 - Council Directive 2006/98/EC
- Revision with a view to:
 - Extending its coverage to other companies or undertakings
 - Reviewing the scope of the definition of I&R

The scope of the Directive

- Elimination of:
 - Double taxation on interest and royalties (“I&R”) payments
- Ensuring that I&R payments are subject to tax once in a Member State
 - Abolition of I&R payments in the Member States where they arise

Taxes covered

- Art. 1(1): obligation on the Member State of the payer to exempt the I&R payments from **any tax**
- Regimes of Member States that limit the amount of deductible interest are not equivalent to a tax on the interest payments and are not covered by the Directive (Case C-397/09 *Scheuten Solar Technology GMBH*)

The notion of “Interest”

- Art. 2(a): definition of interest covers income from:
 - Debts-claims of every kind, whether or not secured by mortgage and whether or not carrying out a right to participate in the debtor’s profits,
 - Securities,
 - Bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures.
- Definition similar to the definition of Article 11(3) OECD MC

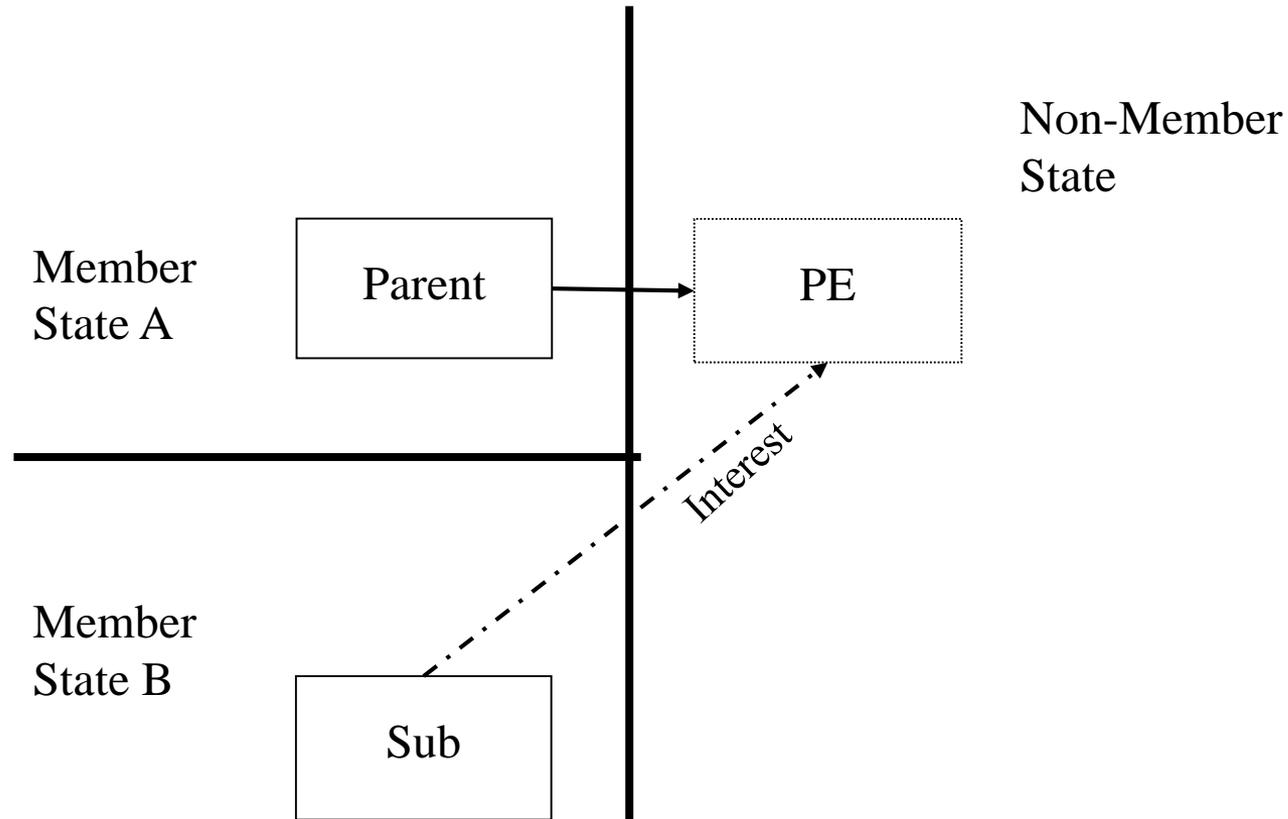
The notion of “Royalties”

- Art. 2(b): payments of any kind received as a consideration for the use of, or the right to use:
 - Any copyright of literary, artistic or scientific work, including cinematograph films and software,
 - Any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience;
 - Industrial, commercial or scientific equipment
- Definition similar to the definition of Article 12(2) OECD MC

Third Countries

- According to Art. 1(8), exemption not applicable if I&R:
“are paid by or to a permanent establishment situated in a third State of a company [resident] of a Member State and the business of the company is wholly or partly carried on through that permanent establishment”

Third Countries



- Directive not applicable if payments received or made by a PE located in a Non-Member State
- Different than the Parent Subsidiary Directive

Payments outside the scope of the Directive

- Art. 4(1): Member State of Source is not obliged to grant exemption in respect of payments that have features of dividend payments. Namely, payments that are:
 - treated as a distribution of profits or as a repayment of capital under the law of the State of source
 - from debt-claims which carry a right to participate in the debtor's profits;
 - from debt-claims which entitle the creditor to exchange his right to interest for a right to participate in the debtor's profits;
 - from debt-claims which contain no provision for repayment of the principal amount (or where the repayment is due more than 50 years after the date of issue)

Article 3 (1) (a): Scope ratione personae

- Three cumulative conditions:
 - Legal forms (see Annex)
 - Residence in a EU Member State
 - Subject to tax in a EU Member State

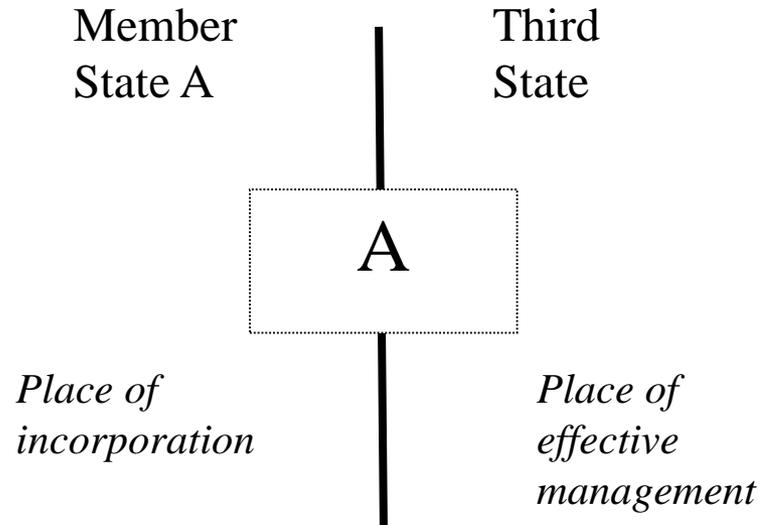
Legal forms

- The company shall take one of the forms listed in the Annex
- Different approaches by MSs
- Closed listing (*e.g.* Romania, Greece, Italy)
- Open listing (*e.g.* UK, Lithuania)
- Closed listing and “incorporation” residual entities clause (*e.g.* Portugal)
 - Public undertakings incorporated in accordance with Portuguese law
- Closed listing and “taxation” residual entities clause (Cyprus)
 - Residual entity must be considered “as a company in accordance with the Income Tax Laws”

Residence

Art. 3(a)(ii):

- The company shall be considered resident for tax purposes of a Member State; and
- Shall not be considered resident only in a third State according to the tie breaker rule of the double tax treaty between the member State of residence and the third State
- Similar to the Parent Subsidiary Directive



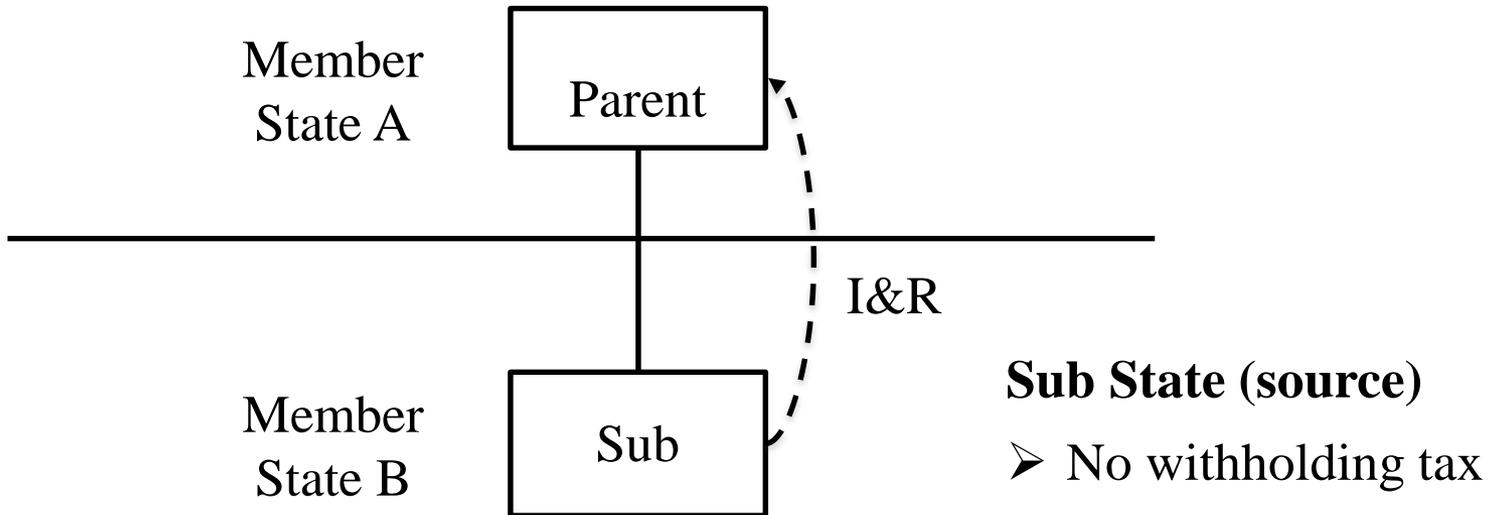
Subject to tax

- Art. 3(a) the Company shall be subject, without being exempt, to one of the taxes listed in the Directive
 - Similar to the Parent Subsidiary Directive (See *Wereldhave* case)
 - 2011 Commission Proposal (COM(2011) 714 final) to specify that the I&R income shall be effectively subject to tax and shall not benefit from any specific exemption

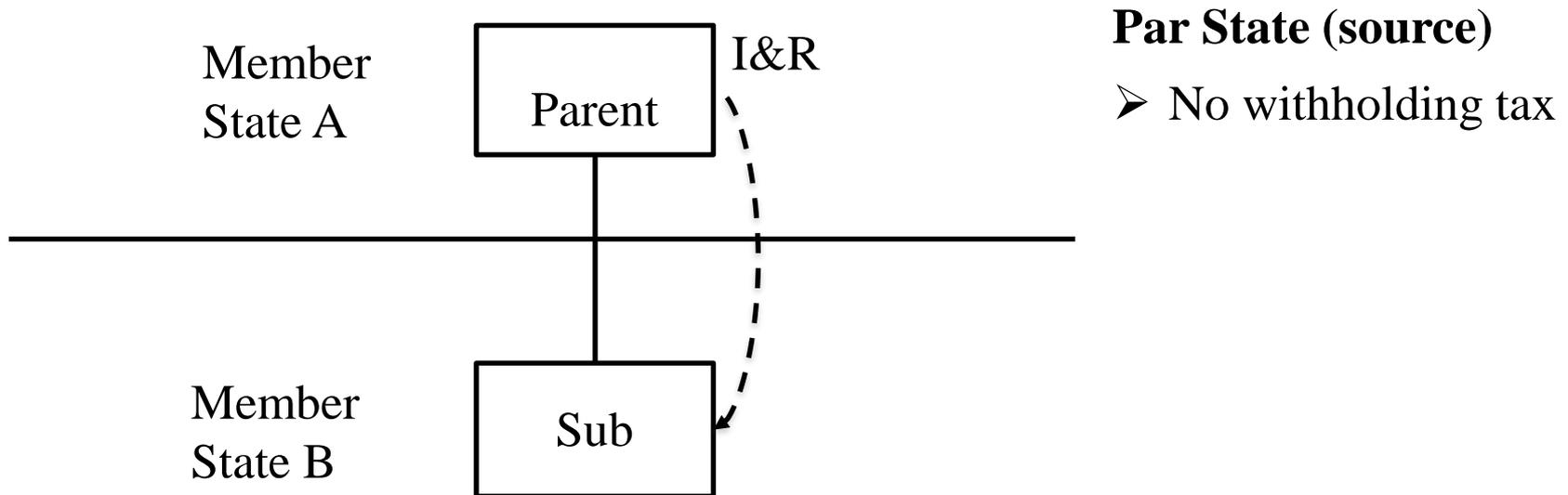
Association requirement (Art. 3b)

- Directive applicable only in cases of direct holdings
- At least 25% per cent of the capital
 - Proposal for reduction COM 2011(714): reduction to 10%
- Member States can unilaterally replace the criterion of capital by the criterion of voting rights
 - Different than PSD
 - Lack of symmetry possible

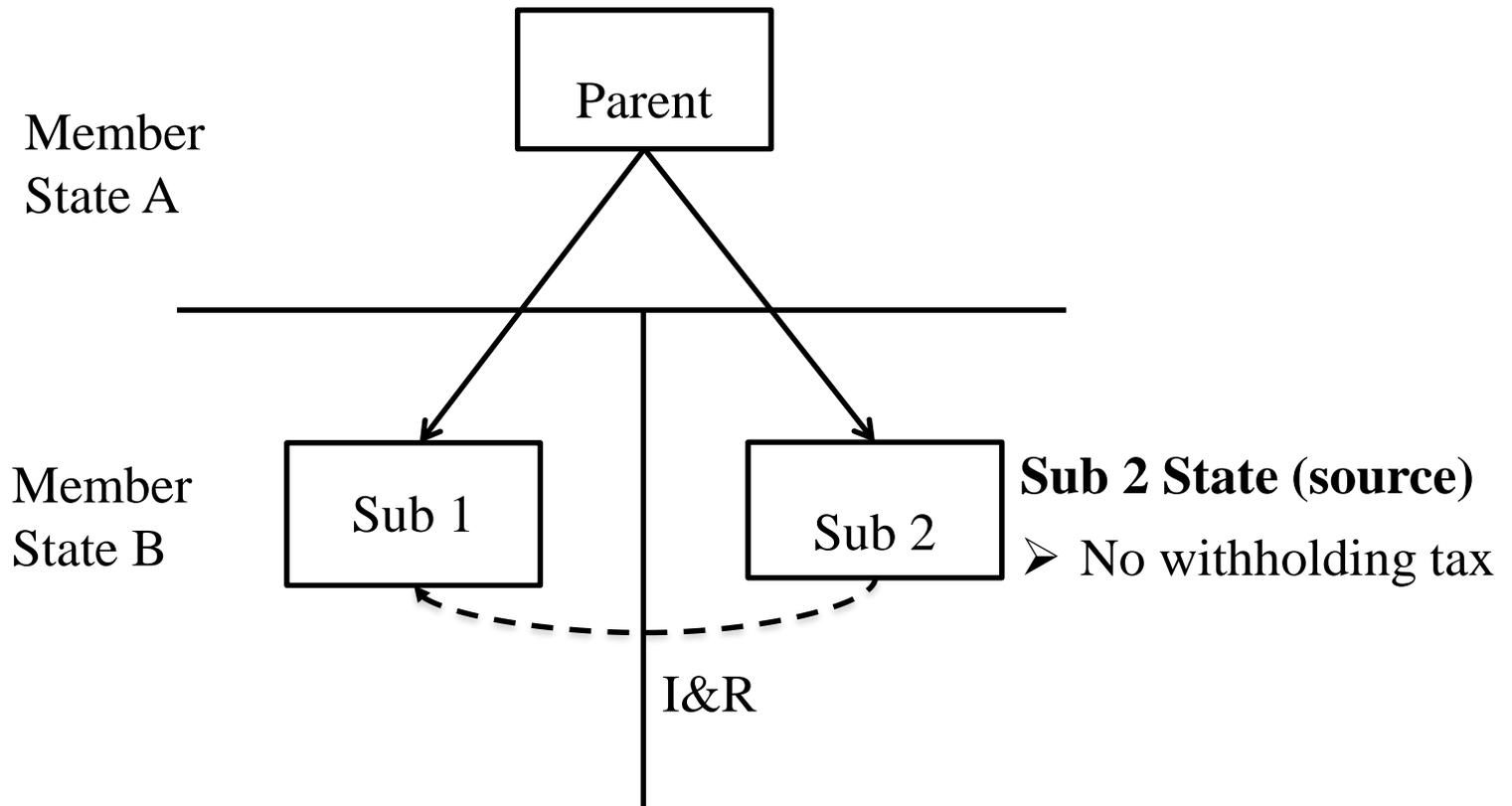
Upstream payments



Downstream payments



Horizontal payments



Holding period

- 2 years
 - Saved lower periods indicated by Member States
 - E.g. Italy: 1 year
- May the requirement be met after the payment?
 - Art. 1(10) I&R: “*conditions set out in Article 3(b) have not been maintained*”
 - Different wording *vis-à-vis* the Parent Subsidiary Directive

Definition of PE

- Art. 3(c): the Directive provides for an explicit definition of PE
 - Similar to the definition included in the Parent Subsidiary Directive
 - Covers only a fixed place of business; no “agency” PE

Sourcing rules

- Art. 1(1)-(2): I&R payments are deemed to arise in the Member State of the company which made such payment
- Art. 1(3): a PE can be considered as the payer of the I&R only if such payment is deductible from its tax base in the Member State in which it is located

The notion of «beneficial owner»

The notion of «beneficial owner»

- Included in the 1977 OECD Model Convention in the “passive income” articles dealing with dividends, interest and royalties to counter “treaty shopping”:
 - Art. 10(2) (*Dividends*): “...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: (...)”.
 - Art. 11(2) (*Interest*): “...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. (...)”.
 - Art. 12(1) (*Royalties*): “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”.

The notion of «beneficial owner»

- **1977 OECD Model Commentary** (par. 12 – Art. 10 – and par. 8 – Art. 11)
 - “...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”.

The notion of «beneficial owner»

- **OECD Report on “Double taxation conventions and the use of conduit companies”** (November 27, 1986)
 - “The limitation is not available when, *economically*, it would benefit a person not entitled to it who interposed the conduit company as an intermediary between himself and the payer of the income (...). The Commentaries mention the case of a nominee or agent. *The provisions would, however, apply also to other cases* where a person enters into contracts or takes over obligations under which he has a similar function to those of a nominee or an agent ”

The notion of «beneficial owner»

- **2003 changes to the OECD Model Commentary** (par. 12 and 12.1 – Art. 10; par. 8 and 8.1 – Art. 11)
- “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 purposes of the Convention, including avoiding double taxation and the prevention of fiscal evasion and avoidance*”.

The notion of «beneficial owner»

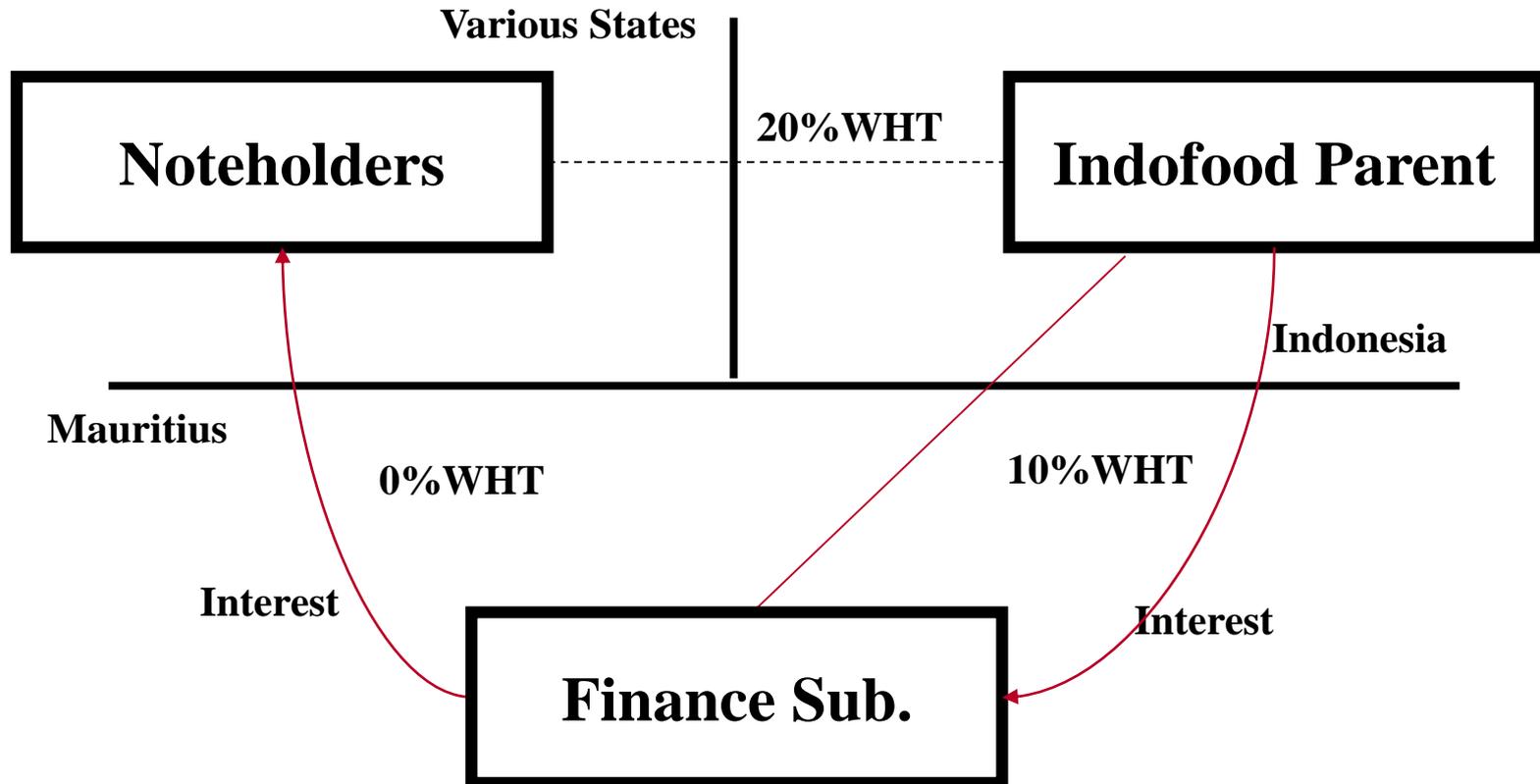
“(…) It would be equally inconsistent with the object and purpose of the Convention for the State of source to grant relief or exemption where a resident of a Contracting State, otherwise than through an agency or nominee relationship, *simply acts as a conduit for another person who in fact receives the benefit of the income concerned*. For these reasons, the report from the Committee on Fiscal Affairs entitled “Double Taxation Conventions and the Use of Conduit Companies” concludes that *a conduit company cannot 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*”.

The notion of «beneficial owner»

- 2014 changes to the OECD Commentary
 - “«beneficial owner» is a concept “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” (para. 12.1).
 - “(...) 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*” (para. 12.4).

Case Law on Beneficial Owner

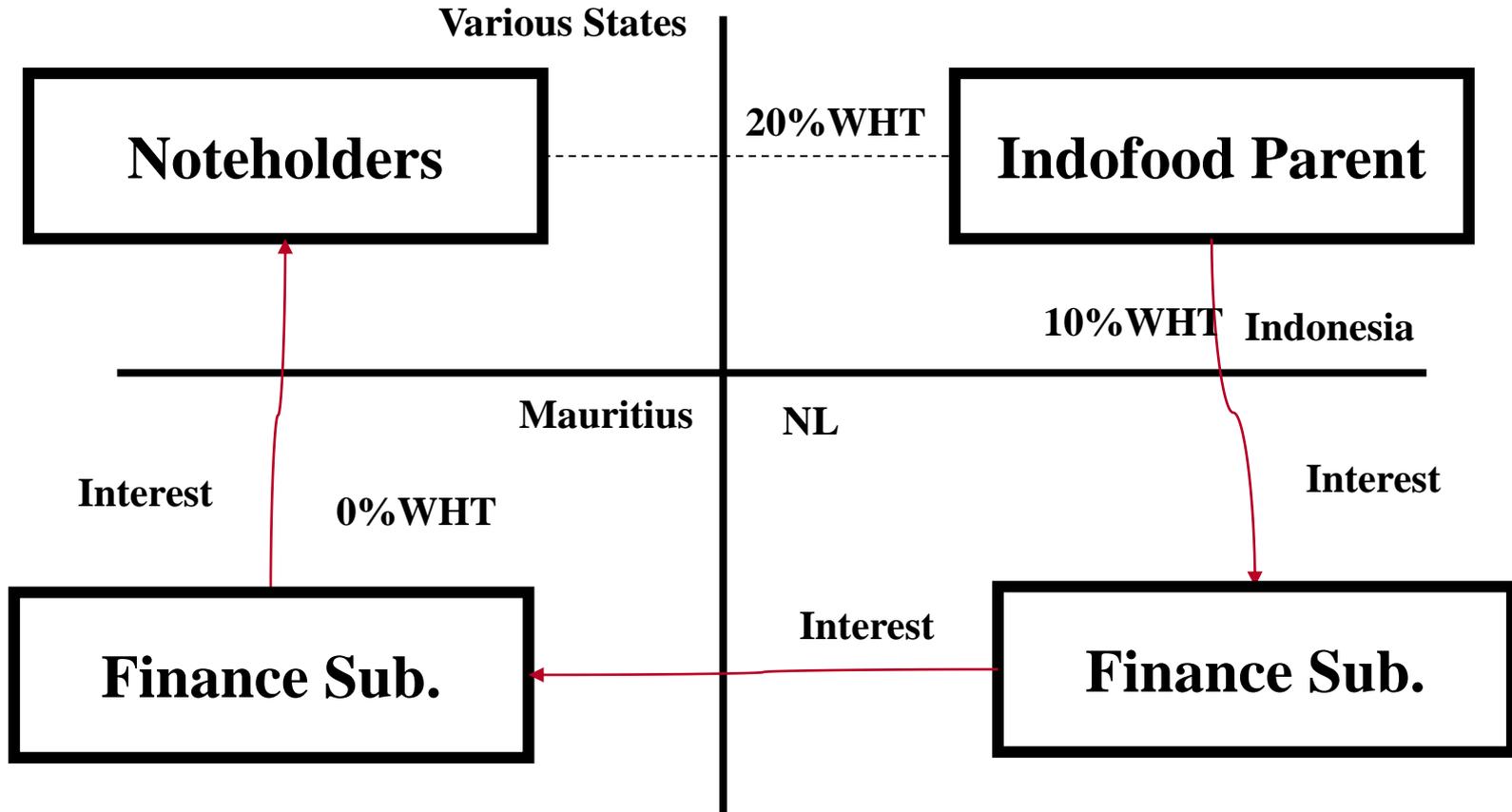
Indofood International Finance Ltd. vs. JP Morgan Chase Bank



Case Law on Beneficial Owner

Indofood International Finance Ltd. vs. JP Morgan Chase Bank

- The structure proposed by the Trustee



Parent-Subsidiary Directive

- There is not a specific provision regarding the concept of «beneficial owner» in the Parent-Subsidiary Directive.
- Recent CJEU Case (C-116/16, C-117/16):
 - *“The mechanisms of Directive 90/435, in particular Article 5, are therefore intended for situations in which, if they were not applied, the exercise by the Member States of their powers of taxation might lead to the profits distributed by the subsidiary to its parent company being subject to double taxation [...] Such mechanisms are not, on the other hand, intended to apply when the **beneficial owner** of the dividends is a company resident for tax purposes outside the European Union since, in such a case, exemption of those dividends from withholding tax in the Member State from which they are paid could well result in them not actually being taxed in the European Union”.*

Interest-Royalties Directive

- Art. 1(4): the Directive provides for an explicit definition of beneficial ownership:
 - “*A company shall be treated as the beneficial owner of the interest or royalties only if it receives those payments for its own benefit and not as an intermediary, such as an agent, trustee or authorised signatory, or for some other person*”
- Art. 1(5): A PE shall be treated as the beneficial owner:
 - if the source of the income (debt claim or right to use the IP) is effectively connected with that PE, and
 - If the PE is subject to tax on the I&R income.

Interest-Royalties Directive

- Recent CJEU Case (C-115/16, C-118/16, C-119/16, C-229/16):
 - The «beneficial owner» is the entity who receives such income and have the effective power of disposal on such interest.
 - In order to define the concept of «beneficial owner» it is appropriate to make reference to the OECD Model Convention and to its Commentary taking into account the various amendments that occurred even after the introduction of the Directive.