AIFI
Associazione Italiana del Private Equity, Venture Capital e Private Debt

fieldfisher

Tax and Legal Issues, January 2020

by Roberto Romito (Fieldfisher)

Italian Supreme Court decision (no. 25490 of 10 October 2019): potential issues for EU holding companies receiving dividends from their Italian subsidiaries in cases where transactions fall within the scope of the EU Parent-Subsidiary Directive

On 10 October 2019, the Italian Supreme Court of Cassation (Supreme Court) issued decision no. 25490 with regard to dividend withholding tax exemption requirements to be met under the EU Parent-Subsidiary Directive (PSD)[1] as implemented in Italy.

According to this judgement, a dividend paid by an Italian subsidiary to its Luxembourg parent cannot benefit from the withholding tax exemption granted by the PSD unless the dividend is subject to actual taxation in Luxembourg.

1. Background

In 2003, an Italian company (ItaCo) paid dividends to its parent - a holding company (LuxCo) incorporated in Luxembourg in 2002 - in turn controlled by an Australian Group[2].

Since, at the time of distribution, the one-year "holding period" requirement provided for by local implementation of the PSD had not been met, the Italian custodian bank - where the shares (44.74%) of ItaCo were deposited - levied a 15% withholding/substitute tax (WHT) according to the combined provisions of the ITA-LUX double tax treaty (DTT) and domestic rules[3].

In 2007, LuxCo, believing it had acquired all the rights to fall within the scope of the EU Parent-Subsidiary Directive, asked the Italian Tax Authorities (ITA) - *Centro Operativo* in Pescara[4] for a refund of the WHT incurred[5].

In 2008, the ITA - having asked the claimant for additional information and documents by means of a Questionnaire - not only rejected the above request through a formal notice of rejection (rejection) but also asked the LuxCo to pay the difference between the domestic rate applicable in 2003 (27%) and the DTT rate (15%) levied at the time of distribution, plus interest and penalties.

In other words, the ITA' position was that neither the PSD nor the DTT could be applied in this case.

2. Appeal at first instance (Provincial Tax Court)

In 2008, LuxCo appealed the case before the Provincial Tax Court in Pescara and raised the following main challenges: a) the rejection was vitiated by a lack of reasoning; b) the rejection was irregularly notified to the claimant by the ITA; c) the rejection used by the ITA to request higher WHT from the claimant was an improper legal instrument; d) the rejection was unlawful in merit since the PSD and DTT should actually apply; e) interest and penalties were not due.

In 2009, the Court issued its decision, upholding the ITA' position and rejecting in full the claimant's appeal.

[1] Directive 90/435/EEC of 23 July 1990 and further amendments.
[2] LuxCo's shareholders were based in Australia and Bermuda.
[3] Art. 10 of the ITA-LUX DTT (1981) and Art. 27-*ter* of Presidential Decree no. 600/1973.
[4] The Italian Tax Authorities' office in charge of tax refund matters for non-residents.
[5] Based on Art. 27-*bis* and 27-*ter* of Presidential Decree no. 600/1973.

The Court above all identified a treaty shopping situation and pointed out that, based on the evidence and documents produced by the parties during the trial, LuxCo appears to be a mere conduit company incorporated without sound economic reasons for the sole purpose of enjoying PSD and DTT benefits (i.e. to avoid a higher WHT rate).

3. Appeal at second instance (Regional Tax Court)

In 2010, LuxCo brought the case before the Regional Tax Court of Abruzzo and, in 2012, the latter entirely confirmed the lower Court decision.

Apart from all the other (rejected) matters, the Court mainly focused its attention on the substantial vs formal aspects of the case. More specifically, the Court affirmed that investigations made by ITA were basically correct and that, although LuxCo could be formally considered to be resident in Luxembourg, it was actually a company without substance and with its effective place of management outside Luxembourg.

Moreover, it argued that LuxCo was incorporated by its non-EU shareholders with the sole purpose of enjoying PSD and DTT tax benefits (i.e. the zero or 15% WHT rate).

In this respect, the Court - although it recognized that a distinction should be made between a holding and an industrial/commercial company - drew its conclusions on the basis of an aggregated set of elements.

In particular, it pointed out that: a) there was no evidence that the company's decisions were actually taken in Luxembourg; b) there was no evidence that board of directors meetings were actually held in Luxembourg; c) the LuxCo's financial statements did not show any costs incurred by the company for offices in Luxembourg; d) only one board of directors member was resident in Luxembourg[6].

In other words, according to the Court, the LuxCo had been incorporated without any valid business reason and could not be considered as the beneficial owner of the dividends.

In addition, as expressly indicated by the claimant in the appeal, those dividends, according to local participation exemption (PEX) provisions, had not actually been taxed at LuxCo level. This aspect was considered the most significant by the Court, which, based on a peculiar interpretation of juridical/economic double taxation mechanisms, essentially asserted that neither PSD nor DTT provisions should apply if dividends are not taxed twice (i.e. in Italy and in Luxembourg).

4. Supreme Court decision

In 2012, LuxCo appealed the case before the Supreme Court. In its first four pleas, the appellant claimed an incorrect interpretation of DTT, PSD and domestic implementing rules where the lower Court affirmed that in order to enjoy WHT protection it is necessary to prove the "effective management" in Luxembourg instead of the mere tax residency.

Moreover, LuxCo complained that the lower Court did not properly take into account the evidentiary effects of the tax certificates issued by the Lux authorities and cited fundamental freedoms (namely, free movement of capital and freedom of establishment) contained in the Treaty of the Functioning of the European Union (TFEU). Furthermore, it asked the Court to refer the case to the Court of Justice of the European Union (CJEU).

Finally, LuxCo complained that the judgment of the lower Court erroneously rejected LuxCo's status as beneficial owner essentially based on the fact that dividends received from ItaCo were not taxed in Luxemburg according to local PEX rules. In the residual pleas LuxCo claimed the lower Court had applied penalties according to an incorrect interpretation of domestic law.

[6] In this respect, the Court stated that although this circumstance is not itself decisive, it in any case represented a clue.

The Supreme Court stated that it was necessary to first make a preliminary remark, namely that LuxCo was established in Luxembourg by non-EU shareholders. In addition, the Court reported that according to the ITA, LuxCo was established for the sole purpose of enjoying PSD and DTT benefits.

Having said that, the Court rejected LuxCo's (first four) pleas. More specifically, it underlined that the mere tax residency status is not sufficient to reach a decision on the dispute and that domestic rules implementing the PSD clearly indicated that WHT exemption does not apply unless the EU recipient - controlled by a non-EU shareholder – can prove that it was not established for the exclusive or main purpose of benefitting from the PSD regime[7].

The decision revealed that the appellant produced two certificates over the years: a) the first one at the time of the refund claim (2007) simply declaring LuxCo's tax residence; b) the second one at a later stage (2009) indicating that LuxCo's effective of place management was in Luxembourg[8] and that under the terms of a DTT concluded with a third State, it was not considered to be resident for tax purposes outside the EU.

In this respect the Court stated that the first certificate was not itself sufficient to obtain PSD and DTT protection. As far as the second certificate was concerned, the Court clarified that it was not true (as claimed by the appellant) that it had been ignored by the lower Court but rather that its evidentiary effects had simply been weighted by the latter on the basis of factual situations (which established that LuxCo was unable to prove that it actually had its place of effective management in Luxembourg).

In addition, the Court declared the absence of any EU freedom violation since LuxCo appears to be a wholly artificial arrangement and for this reason it concluded that there was no need to refer the case to the CJEU.

The Supreme Court then turned its attention to the main aspect addressed by the lower Court, based on the premise that LuxCo was not the beneficial owner of the dividends and that it did not pay any tax on dividends received according to local PEX provisions[9].

The Supreme Court ruled that PSD conditions require that the recipient company must be domiciled for tax purposes in a EU Member State and be subject in Luxembourg to the *impôt sur le revenu des collectivités* without the possibility of an option or of being exempt[10]. LuxCo was found not to have paid taxes in Luxembourg because of the domestic PEX regime.

According to the Court, PSD and DTT provisions have been designed to mitigate juridical and economic double taxation. However, these instruments must not lead to double non-taxation.

As regards the DTT rate (15%) and the beneficial owner status, the lower Court's decision was confirmed, since these represented factual findings that could not be contested at Supreme Court level.

Finally, the Supreme Court ruled in favour of the taxpayer in relation to the penalties (residual pleas) since the domestic provisions invoked by the ITA in order to impose penalties on LuxCo must be referred to the entity liable to pay the WHT on behalf of the recipient – i.e. the Italian intermediary.

5. Comments

The Supreme Court's reasoning in reaching this decision appears convoluted and, in some parts, uncertain. In addition, this decision looks to be based on an improper interpretation of the PSD (and DTT) provisions. Furthermore, taking into account the facts described during the trials, it seems that the Court has contrived its view primarily from an anti-abuse perspective.

---

[7] Art. 27-*bis*, par. 5, of the Presidential Decree no. 600/1973, in force at that time, contained this specific anti-abuse provision.
[8] According to domestic rules and art. 4, par. 3, of ITA-LUX DTT.
[9] Art. 166 of the *Loi de l'impôt sur le revenue.*
[10] Art. 2 par. 1, lett. b) and c) of the PSD in its original version.

However, it is worth remembering that, as far as the restrictive "subject-to-actual-taxation" approach is concerned, this is not an isolated judgement.

Indeed, in the recent past, the Supreme Court has reached essentially the same conclusions in the following other cases: no. 32255 of 13 December 2018; no. 25264 of 25 October 2017 and no. 4771 of 24 February 2017[11].

On the other hand, it should be pointed out that there have also been recent cases - although mainly concerning DTT matters - where the Supreme Court ruled differently, at least on the tax liability requirement: no. 14527 of 28 May 2019; no. 10706 of 17 April 2019; no. 25219 of 11 October 2018 (this case focuses on the cross-border capital gains impact) and no. 29576 of 29 December 2011.

The above peculiar interpretation of the juridical/economic double taxation notion (including the native viewpoint of double non-taxation) promoted by the above-mentioned case law has been repeatedly broadly criticized by Italian doctrine and professionals.

As far as the ITA' position on this topic is concerned, it may be helpful to mention a recent ruling (no. 57 of 15 February 2019) focused on the EU Swiss Savings Agreement and its applicability in case of dividends distributed from Italy. On that occasion the ITA addressed the issue of subjection to taxation/tax liability in a way that is basically in conflict with the Supreme Court conclusions.

In addition, the ITA took a similar view in the past with Resolution no. 167/E of 21 April 2008, Circular Letter no. 26/E of 21 May 2009 and Circular Letter no. 32/E of 8 July 2011[12].

Finally, with regard to the subject-to-tax requirement provided for by the PSD, particular reference should be made to the C-448/15 CJEU *Wereldhave Belgium and Others* case. However, although the judges' conclusions in this (particular) case seem to be in apparent contrast with the Supreme Court case under discussion, they nevertheless do not help to completely clarify this question[13].

6. Possible implications

It is worth noting that all the above negative decisions were caused because the ITA refused to refund WHT to non-resident claimants which then - in order to protect their rights - decided to start tax disputes before the local tax Courts.

Therefore, this decision (and other similar decisions) could affect non-resident taxpayers if they decide (or have already decided) to request WHT refunds under PSD and DTT provisions from the *Centro Operativo* in Pescara, which may rely on this case-law to pursue its own objectives.

Indeed, in the event of WHT refund requests, it is no longer enough for non-resident claimants to provide ITA formally-correct documents (e.g. tax residence certificates and/or foreign tax authorities' declarations) without worrying about additional investigations to be made by the ITA on the substance of the transactions.

---

[11] With parent companies based in Luxembourg, the Netherlands and Belgium respectively.

[12] These last two Circular Letters contain guidelines/clarifications on amendments Italy made to the WHT regime as a result of the infringement procedure launched in 2006 by the EU Commission against Italy, the C-540/07 CJEU *Commission vs Italy* case and other similar - preceding and subsequent - judgements by the same Court. In this respect, in 2008, Italy introduced a 1.375% reduced WHT rate (now lowered to 1.2%) for outbound dividend payments to EU/EEA shareholders that fall outside the scope of the PSD (because, for instance, a holding does not meet the PSD's minimum holding period or percentage) with the aim of eliminating the tax discrimination previously existing - in terms of the final tax burden - between EU/EEA corporate shareholders and Italian corporate shareholders receiving dividends from their Italian subsidiaries, and consequently to be compliant with EU law on free movement of capital and freedom of establishment.

[13] This CJEU judgement was recently cited by the Supreme Court in its decision no. 29635 of 14 November 2019, focused this time on an inbound dividends case (with joint application of PSD and DTT provisions). On that occasion the Court seemed to more properly address the juridical/economic double taxation issue.

We can therefore expect – depending on the various cases - WHT refund procedures to be slowed down or in the worst-case scenario, rejected.

In any case, for cross-border dividend payments within the EU that do not qualify (temporarily or permanently) for the PSD, the potential WHT recovery issue for EU corporate shareholders is currently minimized since a reduced 1.2% WHT[14] may now apply instead of the higher DTT rate (which is generally 10-15%), as happened in the Supreme Court cases indicated above, which dealt with dividend payments made at least 15 years ago[15].

As regards potential tax assessments against Italian subsidiaries distributing dividends to their EU parent companies, the BEPS package (as implemented in Italy), the domestic anti-abuse rules and the recent CJEU decisions on the "Danish cases" (C-116/16 and C-117/16) should give the tax inspectors enough tools, in case of cross-border dividend distributions, to fight against actual pathological abusive structures (where they exist), hopefully without seeking the support of this decision.

[14] See above, footnote 12.

[15] For the record, the full imputation tax credit system for distribution of profits, applicable at that time in Italy for domestic transactions, was abolished and replaced in 2004 by a 95% exemption on distributed dividends.