Italy: Recent case law on the taxation of royalties

Tax Alert

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The court of second instance of Milan[(1)] has ruled that payments made by an Italian distributor to foreign suppliers for the right to distribute copies of software, without any rights to exploit and reproduce the program, are not royalties, but business income. Therefore, such payments are not subject to the Italian 30 percent (final) WHT[(2)].

The court explains its decision by citing paragraph 14.4 of the OECD Commentary on article 12, which clarifies that arrangements under which a software copyright holder grants a distribution intermediary the right to distribute copies of the program without the right to reproduce that program must be dealt with as business profits and not as royalties.

The court decision is surprising because Italy, in its observations on the OECD Commentary on article 12, clearly states that it does not agree that the interpretation in paragraph 14.4 will apply in all cases, but reserves the right to examine each case, taking all circumstances into account. Moreover, the Italian tax authorities have clarified that considerations paid to a non-resident software house by a resident distributor for a licence that entitles it to distribute (but not to reproduce or modify or publicly display) software to the public are for the partial transfer of copyright and must be classed as royalties[(3)].

Italy: entitlement to a reduced WHT requires beneficial ownership

The court of second instance of Milan[(4)] has clarified that, in order to benefit from a reduced WHT rate under a double tax agreement or the Parent-Subsidiary Directive, the foreign recipient of income (royalties and dividends respectively) must demonstrate that it is the actual beneficiary of the income. A mere certificate of residence, issued by the foreign tax authorities, is not sufficient.

(1) Judgment no. 60/29/17 of 18 January 2017.

(2) The WHT is levied on a tax base reduced by 25 percent, leading to a 22.5 percent WHT. The 30 percent WHT may be reduced if there is a double tax agreement between Italy and the country of the supplier.

(3) Italian Revenue Agency Notice no. 128 of 2008.

(4) Judgment no. 5986 of 17 November 2016.

Facts

In order to use a trademark, an Italian company paid royalties to a company resident in the Netherlands and levied the 5 percent reduced WHT under article 12 of the double tax agreement between Italy and the Netherlands (the 'DTA'). The entitlement to the DTA benefits was supported by a declaration, accompanied by a certificate issued by the Dutch tax authorities and stating that the recipient was resident and subject to tax in the Netherlands.

The Italian tax authorities disallowed the favorable tax regime and applied the standard 30 percent WHT rate, claiming that the Dutch parent was not the actual beneficiary of the royalties, based on the facts of the case (e.g. the authorities could not clearly identify the trademark, which was not recorded in the financial statements of the Dutch entity).

Moreover, the same Italian company paid dividends to its parent (resident in Luxembourg) and applied the exemption available under the Parent-Subsidiary Directive(5). Its entitlement to this exemption was supported by a declaration that the conditions imposed by the directive were satisfied(6).

The Italian tax authorities disallowed the exemption, claiming that the EU parent was 100 percent controlled by companies resident in a tax haven outside the EU (in Liechtenstein(7)) and had not adequately demonstrated that it was not established for the sole purpose of benefiting from the special regime available under the Parent-Subsidiary Directive.

Judgment

In both cases the court of second instance of Milan decided in favor of the tax authorities.

In the case of the royalties, it pointed out that entitlement to DTA benefits requires fulfilment of the beneficial ownership requirement. A certificate of tax residence is not sufficient if, from factual evidence, it is clear that the company resident in the Netherlands is an entity interposed between the Italian payer and the real beneficiary of the royalties (i.e. the owner and true licensor of the trademark).

(5) As implemented in Italian tax law under article 27-*bis* of Decree no. 600/73.

(6) The beneficiary must (i) be tax resident in an EU Member State (Luxembourg), (ii) be subject to income taxes without benefitting from beneficial regimes, (iii) have owned the Italian subsidiary's equity for an uninterrupted period of at least one year before being paid the dividends, and (iv) be able to show that benefiting from the special regime under the Parent-Subsidiary Directive was not the sole purpose of the transaction.

(7) This country, which is now on the white list, used to be on the black list for CFC and dividend purposes.

In the case of the dividends, it clarified that, according to the Italian law that implements the Parent-Subsidiary regime(8), when an EU parent is controlled by persons who are not residents of an EU Member State, it is deemed that the EU company is not the actual beneficiary of the dividends. Therefore, the EU parent must demonstrate, for instance through an advance ruling request, that it was not established for the sole purpose of benefiting from the exemption regime. The mere attestation of tax residence in an EU Member State is not sufficient.

Comments

In the Italian tax system, the issue of beneficial ownership is still a controversial one. There is a gap in the law, and statements of practice and case law are not always consistent. Case law confirms that the recipient of income (royalties or dividends) must always be able to demonstrate that it is the real beneficiary, in order to benefit from a reduced rate under a double tax agreement or a directive. Mere compliance with documentation requirements (imposed by the Italian Revenue Agency(9)) is not sufficient, unless supported by factual evidence. With respect to royalties, recent case law has taken a more flexible approach (see, for instance, judgment no. 8303 issued by the court of first instance of Milan on 3 November 2016, according to which a residence certificate is sufficient proof that the recipient of interest is the beneficial owner and is therefore entitled to the exemption available under the Interest-Royalties Directive).

As for the Parent-Subsidiary regime, the Italian law has recently been amended: the clause disallowing the exemption if the EU parent is controlled by a person resident in a third country outside the EU (unless that parent can demonstrate that it was not established for the sole purpose of benefiting from the exemption) has been repealed and replaced by a generic reference to the general anti tax-abuse/avoidance rule.

(8) See article 27-*bis* (5) of Decree no. 600/73, before the amendments introduced by Law no. 122 of 2016.

(9) See the Regulation of 10 July 2013, which approved the forms that the beneficial owner must provide to the withholding tax agent.

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