The EU Interest and Royalty Directive: The Italian Perspective

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1. Introduction

After almost 15 years, EU Member States have agreed upon common rules governing the taxation of cross-border interest and royalty payments between EU resident companies.The first proposal for a Directive to abolish withholding taxes (normally) levied on interest and royalty payments between companies resident in different Member States, was presented by the European Commission on 6 December 1990.[1] Although the Ruding Committee quoted this Directive in 1992 amongst its priorities for facilitating the establishment of the Single Market, the Council was unable to reach a consensus and finally withdraw the proposal in 1994. As a consequence of the debate which commenced with the Commission Meeting of 5 November 1997, concerning 'A package to tackle harmful tax competition in the European Union', on 1 December 1997 the Ecofin Council urged the European Commission to submit a proposal for a new Directive on interest and royalty payments.

On 4 March 1998, the European Commission put forward a new proposal for a Directive to abolish double taxation of interest and royalty payments between associated companies of different Member States, which was then submitted for approval on 6 March 1998.[2]

On 17 September 1998,[3] the European Parliament approved the Commission's proposal, subject to certain amendments. At the time the need to establish a harmonized legal framework within the EU, in order to ensure that tax competition did not develop between Member States, was emphasized.

Following an in-depth debate at the Council during which all delegations agreed upon the draft Directive, the Ecofin meeting held on 3 June 2003 finally approved the Directive 2003/49/CE, (the Directive), which was then published in the *Official Journal* of the European Union on 26 June 2003.

The purpose of the Directive is to exempt interest and royalty payments made by a company from a Member State, to an associated company in another Member State, from any withholding tax in the source state (nil withholding tax regime). Moreover, as explained in Mr. Carlo Secchi's[4] Report, the Directive is designed not to facilitate non-taxation, but to relieve double taxation and to avoid tax-related issues for EU companies engaged in cross-border business activities within the EU.

This article aims to consider the scope and extent of the Directive, in the light also of the new rules introduced by Italian tax reform. An additional element of analysis is whether the Directive is self-executing, given that Italy has failed to ratify the Directive by 1 January 2004.

Notes

1. OJ, C/53, 28 February 1991.
2. OJ, C/123, 22 April 1998.
3. OJ, C/313, 12 October 1998.
4. Report on the proposal for a Council Directive on a common system of taxation applicable to interest and royalty payments made between associated companies from different Member States, made on 3 September 1998 to the Committee on Economic and Monetary Affairs and Industrial Policy.

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2. Italian withholding tax regime on interest and royalty payments to a non-resident company

At present, under Art. 26, para. 5, of Law no. 600/1973, interest payments made by an Italian resident company to a non-resident company under a loan agreement are subject to withholding tax at source, levied at 12.5 per cent. Where the beneficiary is resident in a tax haven country,[5] the rate of withholding tax is 27 per cent. According to the last paragraph of Art. 25, Law no. 600/1973, royalty payments made by an Italian resident company to a non-resident company are subject to withholding tax at source levied at 30 per cent, calculated on the taxable amount of royalties.

In the event of a double taxation treaty between Italy and the recipient's country of residence of the recipient, the withholding tax rate for both interest and royalty payments might be reduced accordingly. However, the reduced withholding tax rate of royalty payments under the treaty will apply to the gross amount paid, rather than to the taxable amount.

3. Conditions for eligibility for the nil withholding tax regime

Article 1 of the Directive provides that a EU resident company may take advantage from the nil withholding tax regime on cross-border interest and royalty payments, provided that a number of conditions are met. It should be noted that some conditions must be satisfied with regard to both interest and royalty payments, whilst the applicability of other specific conditions depends upon the nature of the payment made/received.

First, the beneficial owner of the interest and/or royalty shall be a company from another Member State, a permanent establishment situated in another Member State, of a company from a Member State.

According to Art. 3, letter a), the payer and beneficiary must be incorporated in one of the forms provided for by Annex 1 of the Directive (e.g. for Italy, a company incorporated as an S.p.A. or S.r.l.), and subject to corporate tax in their country of residence, without the option of exemption.

A. Associated Company condition

In addition, payer and beneficiary must belong to the same Group. This condition is deemed to exist where the shareholding is of at least 25 per cent. More specifically, according to Art. 3, letter b), two companies are associated where:

- the first company has a direct minimum holding of 25 per cent of the capital of the second company, or
- the second company has a direct minimum holding of 25 per cent of the capital of the first company, or
- a third company has a direct minimum holding of at least 25 per cent of the capital of both the first and the second companies.

It should be noted that the holding must be direct, according to the interpretation by most (Italian) authors,[6] and according to the first draft of the Directive, indirect holdings should not be taken into account. In addition, the holding should involve EU companies only.

Even if, pursuant to Art. 8 of the Directive, the Commission reports to the Council by 31 December 2006, on the issue of whether or not to extend the nil withholding tax regime to non-Associated Companies, the rationale of the present restriction to interest and royalty payments to Associated Companies only, is difficult to understand.[7]

With regard to the direct v/s indirect holding issue, it should be noted that in the first draft of the Directive, dated 6 March 1998,[8] the definition of Associated Company was based upon a minimum holding of 25 per cent, whether direct or indirect.[9]

To understand the rationale, if any, behind the amendments made to the Associated Company definition provided for in the first draft of Directive, we outline below the debate on the topic which took place within the EU institutions, from 6 March 1998 until 3 June 2003 (the date on which the Directive was finally approved).

The Committee on Economic and Monetary Affairs and Industrial Policy, in its Report dated 3 September 1998, reiterated the importance of extending the nil withholding tax regime also to interest and royalty payments between companies which are not associated.Moreover, in the Opinion of the Economic and Social Committee, also, as given in the meeting of 14 September 1998,[10] the scope of the Directive was too

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5 The list of Tax Havens was published in the Ministry of Finance, Decree of 23 January 2002.

6 See E. Mignarri, 'La definitiva approvazione della Direttiva comunitaria sulla fiscalità del risparmio: le norme e i riflessi operativi in Italia', Il Fisco no. 34 of 22 September 2003; G.M. Committeri and G. Scifoni, 'Senza ritenuta alla fonte I pagamenti di interessi e canoni intracomunitari', Corriere Tributario no. 38.

7 See D. Weber, 'The proposed EC Interest and Royalty Directive', *EC Tax Review* 2000, no. 1.

8 OJ, C/123, 22 April 1998.

9 See J. David and B. Oliver, 'The proposed EU interest and Royalties Directive', *Intertax*, vol. 27, nos. 6-7.

10 OJ, C/284, 14 September 1998.

limited. The measure adopted (i.e. nil withholding tax regime) was fully justified only where interest and royalty payments were made between companies which were not in a dependent relationship. Therefore, according to the Opinion of the Economic and Social Committee, there were no particular grounds for restricting the scope of the nil withholding tax regime solely to interest and royalty payments made between Associated Companies.

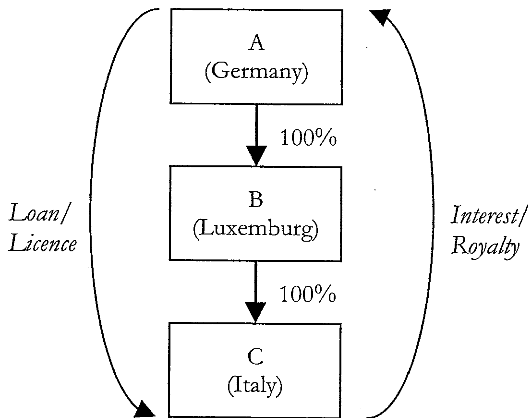
On 17 September 1998,[11] the European Parliament, in the session debating upon the approval of the proposed Directive, raised the same issue and proposed extending the nil withholding tax regime to interest and royalty payments made between companies which are not associated, as part of the measures to be implemented to develop the Single EU Market.

In the Forum organized by the *Confédération Fiscale Européenne* and held in Brussels on 21 April 1999, the option of restricting the nil withholding tax regime to payments made between companies which are Associated via a direct holding, was discussed – an option which conflicted with the opinion expressed by the said EU institutions. This point was raised by Mr. Del Giudice, the representative of the Italian Ministry of Finance, who expressed his disagreement with the definition of Associated Company as including indirect holdings.

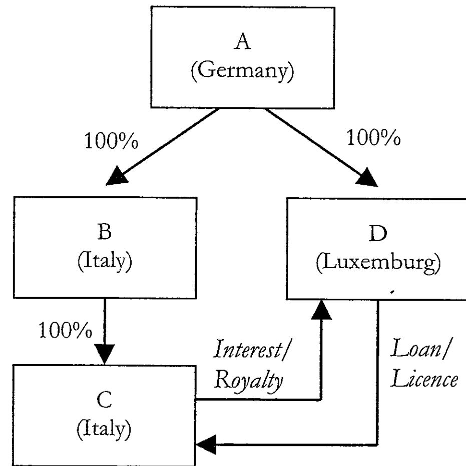
Unexpectedly, at the Ecofin Meeting held on 25 May 1999, it was then agreed to restrict the scope of the Directive solely to those companies associated by way of a direct capital holding. This decision was reiterated at the Ecofin Meeting held on 26–27 November 2000, at the Council of the European Union held in Brussels on 11 May 2001, at the Ecofin Meeting held on 21 January 2003, until the Directive was finally approved on 3 June 2003.

Therefore, in the light of the definition of Associated Company, as provided for by Art. 3, letter b) of the Directive, not all interest and/or royalty payments between EU companies belonging to the same group, will benefit from the nil withholding tax regime. For example, in cases 1 and 2, interest and royalty payments will not qualify under the Directive, and the nil withholding tax regime will only be applicable in cases 3 and 4.

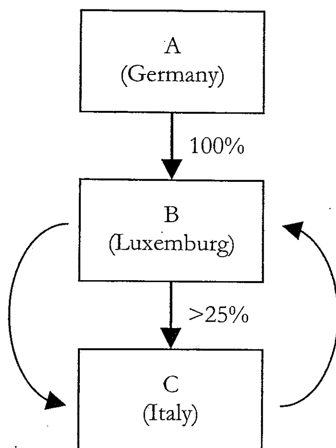
Case 1



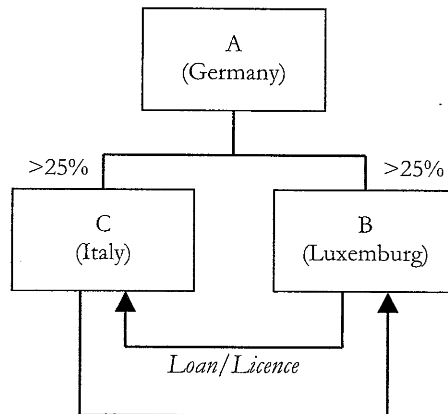
Case 2



Case 3



Case 4



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[11] OJ, C/313, 12 October 1998.

B. Beneficial ownership condition

The nil withholding tax regime will only apply on condition that the beneficial owner of the interest and royalty payments is a company of another Member State. It should be noted that, under Italian tax law, there is no definition of beneficial ownership, and we will have to refer to the interpretation provided for in connection with double tax treaties.

According to Art. 1, para. 4 of the Directive, the beneficial owner is defined as 'a company ... that receives those payments for its own benefit and not as an intermediary, such as an agent, trustee or authorised signatory, for some other person'. n the Opinion of the Italian Tax Authorities,[12] the 'subject to tax' condition is the element to be taken into consideration when ascertaining who is the beneficial owner of a payment under a double tax treaty. This position is confirmed by the Addendum to the Italy-Germany Double Tax Treaty, where the beneficial owner is defined as the person which, in receiving dividends, interests or royalties, has full rights over the same and where such payments are attributed to him according to the tax laws of the Contracting States.

However, we cannot exclude any potential issues that may arise given that the beneficial owner concept may differ from country to country, and Italy, in particular, may have a different, and perhaps stricter, interpretation.

Under Directive 2003/48/CE, regarding the taxation of savings income in the form of interest payments,[13] the beneficial owner is defined as '... any individual who receives an interest payment for his own benefit'.

Where interest and/or royalty payments are channelled via EU-resident companies, ending up in non-EU entities, I am of the opinion that consideration should be given, in conjunction with the beneficial ownership condition, to the anti-avoidance provision provided for by the Directive, Art. 5, para. 2, according to which a 'member State may, in the case of transactions for which the principle motive or one of the principle motives is tax evasion, tax avoidance or abuse, withdraw the benefit of this Directive or refuse to apply this Directive'.

4. Anti-avoidance provisions

Article 4 of the Directive contains a number of anti-avoidance provisions which apply according to the nature of the payment (i.e. interests v/s royalties). The source state shall not be obliged to grant the benefits of the nil withholding tax regime in case of payments:

- which are treated as a distribution of profits or as a repayment of capital under the law of the source state (e.g. thin capitalization anti-avoidance provisions);
- from debt-claims which exercise a right to participate in the debtor's profits (e.g. profit sharing loans);
- from debt-claims which entitle the creditor to exchange his right to interest with a right to participate in the debtor's profits;
- from debt-claims which contain no provisions regarding the repayment of the principal amount or where the repayment is due more than 50 years after the issue date.

In respect of point (i), it should be noted that Art. 98 of the Italian tax reform will, from 1 January 2004, introduce thin capitalization anti-avoidance provisions. Disallowed interest payments will be treated as dividends for the recipient (this will be considered in detail below).

The Directive provides that where, by reason of a special relationship between the payer and the beneficial owner of the interest or royalties, or between one of them and another person, the amount of the interest or royalties exceeds the amount which would have been agreed by the payer and the beneficial owner in the absence of any relationship, the nil withholding tax regime shall only apply to the latter amount.

Moreover, the recipient of interest or royalties must be a company that receives those payments for its own benefit, and not as intermediary (i.e. as an agent, trustee or authorised signatory) for any other person. This is the so-called beneficial ownership condition which is dealt with above.

Finally, according to Art. 5, para. 2, a Member State may withdraw the benefit of the nil withholding tax regime in case of transactions for which the principal motive is to benefit from the said provisions. This might well be considered as a general anti-avoidance provision, and the extent of the same appears to be very wide-ranging and subject to different interpretations by different Member States.

A. Italian tax reform: impact of thin capitalization anti-avoidance provision

On 1 January 2004, the Tax Reform will introduce, with Art. 98, a thin capitalization anti-avoidance provision. The said anti-avoidance provision will have to be taken into consideration, in conjunction with the directive, where a financing reorganization is needed in order to benefit from the nil withholding tax regime and in case interest payments are disallowed.

Pursuant to the said rules, interest payments on loans granted or guaranteed by qualified shareholders and related parties, will not be tax deductible for the amount relating to the so-called excess loan, i.e. loans exceeding the 4:1 debt to equity ratio. qualified

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12 Tax Authorities Statements of Practice no. 306/E, dated 23 December 1996; no. 12/431 dated 5 May 1987 and no. 104/E, dated 6 May 1997.

13 OJ, L/157, 26 June 2003.

shareholder is anyone holding, directly or indirectly, at least a 25 per cent share of the share capital issued by the borrowing company.

According to Art. 98, para. 3, letter b), the definition of 'related parties' to the qualified shareholder includes 'companies controlled pursuant to Article 2359 of the Italian Civil Code and, in case of individuals, relatives, as provided for under Article 5, paragraph 5'. It is my opinion that the above definition of 'related party' may lead to penalizing effects for the tax deductibility of interest for the borrowing company. As an example, company A holds the entire issued share capital of companies B and C, which, in turn, respectively hold a 50 per cent share in the capital of the Italian company D. In this case, pursuant to the definition of qualified shareholder and related parties, companies A, B and C are qualified shareholders. Moreover, companies B and C are related parties of A but, pursuant to the wording of the said para. 3 of Art. 98, it is questionable whether B and C are also related parties. Therefore, if D has received a loan from B, for the purpose of the computation of the debt to equity ratio, the full loan amount will be taken into account, whilst only 50 per cent of D's net equity will be computed for the purpose of the debt to equity ratio.

Another aspect worth considering is the provision of Art. 4, para. 1, letter a) of the Directive, according to which the source state (e.g. Italy) shall not be obliged to grant the benefits of the nil withholding tax regime for interest payments which are treated as a distribution of profits or as a repayment of capital under the law of the source state (e.g. new Italian thin capitalization anti-avoidance provisions).

In the latter case, the question is whether interest payments, disallowed according to Art. 98 of the new Italian Tax Code and re-characterized as dividends, can benefit under Directive 435/90/CE. In this respect, the Opinion of the Economic and Social Committee, as given in its meeting of 14 September 1998, was to amend the Directive to specify that interest payments re-qualified as dividends according to the Member State tax law, could benefit from the Parent-Subsidiary Directive; this provision was not reflected in the final version of the Directive.

5. Level of flexibility for individual Member States in implementing the Directive

With regard to the level of flexibility left to individual Member States in implementing the Directive, it should be noted that:

- a Member State shall have the option of not applying the Directive if the Associated Company conditions have not been maintained for an uninterrupted period of at least two years; *and*
- the source state may require the fulfilment of the requirements to be substantiated, at the time of payment of the interest or royalty, by an Attestation: the said Attestation shall be valid for a period of between one to three years, whilst a decision on exemption might also be required, to be provided within three months of the Attestation having been submitted to the competent tax authorities by the beneficiary of the interest or royalty; *and*
- in the definition of Associated Company, a Member State shall have the option of replacing the criterion of a minimum holding in the capital with that of a minimum holding of voting rights.

A. The attestation requirements

As explained above, the source state may require fulfilment of the requirements to be substantiated, at the time of payment of interest or royalty, by an Attestation, to be issued by the tax authorities of the recipient's country of residence, confirming that the recipient qualifies for the nil withholding tax regime. If fulfilment of the requirements has not been attested at the time of payment, the Member State shall be free to require tax withholding at source.

According to Art. 1, para. 13 of the Directive, the Attestation should confirm the following.

- The receiving company is resident for tax purposes in the said country, or has a permanent establishment in such country. A certificate of residence for tax purposes, issued by the competent tax authorities, should be attached to the Attestation.
- The beneficial ownership condition is fulfilled.
- The recipient is subject to corporation tax without the option of being exempt.
- The Associated Company condition is fulfilled.
- Member States may also request proof of the legal justification for the interest/royalty payments (e.g. copy of the loan or licensing agreement).

It should be noted that, under Italian tax law, similar Attestations are already required in order to benefit from the nil withholding tax regime on dividends under Directive 435/90/CE and reduced withholding tax rates under double tax treaties.

Interest, royalty and dividend payments made by an Italian resident to a non-resident are subject to withholding tax at source, the Italian resident payer acting as withholding agent. This holds true even where the said withholding tax is reduced according to a double tax treaty or where Directive 435/90/CE applies.

The Italian Tax Authorities, with Statement of Practice no. 86/E, dated 13 September 1977, ruled for the direct applicability of the reduced (or nil) withholding tax under double tax treaties, on condition that the recipient submitted a declaration to the Italian withholding Agent, with evidence:

- of the receiving company's tax residence;
- that the conditions provided for by the Double Tax Treaty are met; and
- that there is no permanent establishment in Italy.

The responsibility of the Italian withholding agent is

limited to verifying the contents of the said Attestation.[14]

Stricter rules on the direct applicability of double tax treaties were introduced with Statement of Practice no. 2 of 4 February 1980, according to which the Italian withholding agent, in relation to the non-resident (Swiss) recipient, had to request an Attestation from the Swiss tax authorities, confirming that the recipient:

- had no permanent establishment in Italy;
- was a tax resident of Switzerland and subject to tax; and
- that all the other conditions required in order benefit from the provisions of the Treaty were met.

With Statement of Practice no. 7 of 25 March 1981, the above practice was extended to all double tax treaties in force.

However, the Italian tax authorities, with Statement of Practice no. 126/E, dated 26 July 1999, ruled that the Attestation, as issued by the tax authorities of the recipient's country of residence, should only confirm the recipient's residence for tax purposes – with the other conditions required in order to benefit from the double tax treaty provisions to be confirmed by the same recipient.

With regard to the nil withholding tax regime provided for by Directive 435/90/CE, according to Art. 27*bis*, para. 3, of Law 600/1973, this is directly applicable, provided that the dividend recipient (the parent company) issues its Italian subsidiary with an attestation confirming that:

- the participation has been held for at least 12 months; and
- the participation is of at least 25 per cent.

In addition, an Attestation from the local tax authorities must be provided, to confirm:

- the tax residence status;
- the legal form; and
- that the condition of being subject to tax is met.

B. The advance ruling

According to Art. 1, para. 12 of the Directive, the source state may make the benefit of the nil withholding tax regime conditional upon an advance ruling request, to be provided within three months and valid for a period of at least one year after its issue. It should be noted that Italy has little practice in ruling requests.

At present, under Italian Tax rules, a general ruling is possible, according to Art. 11 of Law no. 212, dated 27 July 2000 (the so-called '*Statuto dei diritti del contribuente*'), which deals with the enforcement of a tax law whether there are doubts concerning the interpretation of any given tax provisions. In addition, the Italian Tax Code provides other specific advance rulings which may be used to disallow, or prevent, the application of anti-avoidance provisions.[15]

6. The entry into force: is the Directive self-executing?

With the exemptions of Greece, Portugal and Spain, each Member State (Italy included) shall enforce the laws, regulations and administrative provisions necessary to comply with the Directive by no later than 1 January 2004, the effective date of the provisions introducing the nil withholding tax regime on interest and royalty payments. In the event that Italy does not implement the same within this deadline, it is questionable whether it can be argued that the Directive is self-executing (i.e. exercises its effect even if not ratified by the Member State).

According to several ECJ precedents,[16] the transposition of a Directive into domestic laws does not necessarily require express formal incorporation. It should be noted that the Italian Supreme Court[17] has ruled in favour of the ECJ's position, asserting that the conditions for a Directive to be self-executing in a Member State have to be tested according to EU law.

A Directive is self-executing where its provisions are clear, precise and unconditional. A provision is unconditional[18] where it is not subject, in its implementation phase or in the explication of its effects, to action to be taken either by Community institutions or by the Member States. If we consider the provisions of the Directive in question, these should be considered as being clear and precise, the issue being whether we are also able to contend that they are unconditional in view of the level of flexibility left to each Member State in the implementation phase.

To assert whether the Directive is also unconditional, we might consider the debate and comments[19]

Notes

14 According to Statement of Practice no. 147, of 25 November 1978 if, in the event of assessment, the Attestation is found to be untrue, the withholding agent is not held responsible.

15 Article 127*bis*, para. 5 of Law Decree no. 917/1986; Art. 37*bis*, para. 8 of Law Decree no. 600/1973.

16 Court Case no. 41/74, 4 December 1974; Court Case no. 148/78, 5 April 1979; Court Case no. 8/81, 19 January 1982; Court Case no. 286/85, 24 March 1987; Court Case no. 80/86, 8 October 1987; Court case no. 103/88, 22 June 1989; Court Cases no. 231/87 and 129/88, 17 October 1989; Court Case no. 64/90, 1 October 1991; Court Case no. 236/92, 23 February 1994; Court Case no. 194/94, 30 April 1996; Court Case no. 188/95, 2 December 1997; Court Case no. 56/98, 29 September 1999.

17 Court Case no. 170, 5 June 1984, Court Case no. 64, 18 January 1990, and particularly Court Case no. 168, 8 April 1991.

18 See Court Case no. 236/92, 23 February 1994.

19 See Maisto, 'La direttiva Cee relativa al regime tributario dei dividendi nei rapporti tra "società-figlie" e "società-madri" ', *Rivista di Diritto Tributario* 1992.

made in relation to other tax Directives. For example, with regard to Directive 435/1990/CE, it was affirmed that it fulfilled the conditions of clearness and accuracy and therefore was self-executing. By comparing Directive 435/1990/CE with the Directive in question, it emerges that, in both cases, Member States are given the option of not applying the provisions to a company of another Member State in circumstances where the Associated Company condition has not been maintained for an uninterrupted period of at least two years.

In addition, with Directive 435/1990/CE also, Member States were given the option of replacing the criterion of a minimum holding in the capital with that of a minimum holding of voting rights. The only main difference is the possibility for Member States to request, under the Directive at issue, the Attestation and the advance ruling.

In light of the level of flexibility left to each Member State in implementing the Directive, I believe that, where the conditions to benefit from the nil withholding tax regime are met, and:

- the Associated Company Condition is met in the form of:
  - uninterrupted direct ownership for a period of at least two years; and
  - direct minimum holding of at least 25 per cent of both the company capital and voting rights; and
- written confirmation from the tax authorities in the recipient's country of residence is obtained, stating that all the requirements necessary to benefit from the nil withholding tax regime are met (i.e. Attestation confirming the condition for exemption); and
- a ruling request is filed with the Italian tax authorities, if the reply is affirmative or if no reply is received within three months,

it is possible to argue that, even if Italy uses the maximum flexibility granted in implementing the Directive, we fall within the scope of application of the nil withholding tax regime. In this situation, I feel that there would be a strong case for arguing that the Directive is self-executing, so that a company can rely on it directly in order to claim the benefit of the nil withholding tax regime from 1 January 2004.

With reference to the need for the Attestation and the advance ruling request, these could be regarded as procedural issues.[20] In addition, we might face a number of practical problems in, say, filing and obtaining the advance ruling, as no guidelines are available to both the taxpayer and the tax authorities. We would, therefore, have to refer to the procedures for ordinary ruling requests.

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20 See S. Raventos, 'On the Interest and Royalties Directive, or How an Espresso Measure May Become a Decaf One', *European Taxation*, July 2000.

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