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ECONOMIC SUBSTANCE OVER FORM IN INTERNATIONAL TAXATION – A EUROPEAN VIEW?

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Outline of presentation

- Substance-over-form and the permanent establishment ("PE"): a dangerous myth;
- Substance-over-form and the concept of "beneficial owner": a shared reality.
Substance and form and the PE: an overview in relevant European judicial cases

- European courts decisions are not unanimous about the prevalence of the substance-over-form approach or of a formal one in the interpretation of the concept of PE;
- The cases analyzed will demonstrate that there is not actually a common interpretation.
Form-over-substance approach

Zimmer Ltd case, Conseil D’Etat, 2010, nn. 304715

- Zimmer Ltd., an UK company, sold its orthopedic products in France through its affiliate Zimmer SAS, under a buy/sell arrangement; in 1995, the arrangement was converted into a commissionnaire agreement. Thereafter the French Tax authority claimed that Zimmer Ltd. had an agency PE in France.
Form-over-substance approach, cont’d

- Dell Products case, Supreme Court of Norway, December 2, 2011, nn. HR 2011 – 02245 – A;

- Dell Products, an Irish company, sold its products to customers in Norway through Dell AS, a Norwegian company which acted as a commissionaire. The Norwegian Tax Authority considered Dell AS a dependent agent.
Form-over-substance approach, cont’d

- Both the French and Norwegian Courts adopted a form-over-substance approach in interpreting the agent PE issue;
- Commissionnaire agreements do not legally bind the principal and therefore they cannot substantiate a PE of the principal.
Recent OECD developments: a substance-over-form approach

- The OECD has recently (October 2012) issued a discussion draft ("DD") on the "Interpretation and Application of Article 5 (PE) of the OECD Model Tax Convention";

- The DD suggests a new interpretation of the "agency clause" of art. 5, par. 5 of the OECD Model and to amend correspondingly the Commentary.
Recent OECD developments: a substance-over-form approach, cont’d

- Purpose of the proposal: to guarantee that the meaning of “*to conclude contracts in the name of enterprise*” should not be interpreted in a formal way;

- Contracts concluded by an “undisclosed agent” can give rise to a PE, if they are economically, but not legally binding on the principal.
Comments on the OECD proposal

- In which cases the enterprise could be “economically bound”, but not “legally bound”;
- The Commentary should consider that the term “undisclosed agent” may be interpreted differently in civil and common law jurisdictions;
- The Commentary should clarify whether and in which cases a commissionnaire agreement could give rise to a PE.
Risks connected to the substance-over-form approach: the Philip Morris case

- Philip Morris case, Italian Court of Cassation, decisions nn. 3367, 3368, 7689 and 17373 of 2002;
- Intertaba S.p.A., an Italian company, engaged in manufacturing and distributing cigarette filters in Italy, under a contract between Philip Morris GmbH and the Italian State Monopoly.
Risks connected to the substance-over-form approach: the Philip Morris case, cont’d

- Intertaba supervised the execution of the contracts with the Monopoly and promoted the sales of Philip Morris products; Philip Morris GmbH received royalties from the Monopoly;
- According to the Italian Tax Authority such royalties were attributable to an undisclosed PE that the group maintained in Italy.
Risks connected to the substance-over-form approach: the Philip Morris case, cont’d

➢ In interpreting the clauses of an agreement and to ascertain whether the foreign company maintains in Italy a PE, the Italian Court recommends a substance-over-form approach.
Risks connected to the substance-over-form approach: the Philip Morris case, cont’d

➢ Such interpretation may lead to the absurd result that “A direct participation of resident company’s representatives in the negotiations of contracts concluded by the principal may be assimilated to conclude contracts in the name of the foreign company, even lacking the formal power of representation”.
Risks connected to the substance-over-form approach: the Philip Morris case, cont’d

- Although the OECD Commentary (par. 33 of art. 5) has been amended after the Philip Morris decision, clarifying that the mere participation in the negotiations of the subsidiary’s employees do not imply a PE, the Italian courts, based on the substance-over-form approach, have in several cases confirmed the Philip Morris decision.
The substance-over-form and the concept of “beneficial owner”: an overview in relevant European judicial cases

Differently from the situation concerning the PE, it appears that the European courts share the view that in interpreting the term “beneficial owner” the substance-over-form approach should be privileged.
Substance-over-form approach

- ECJ, C-222/04, Ministero dell’Economia e delle Finanze vs. Cassa di Risparmio di Firenze S.p.A;
- Cassa di Risparmio di San Miniato Foundation, an Italian holding company, claimed the exemption from the withholding tax on dividends deriving from its participation in the share capital of two Italian companies.
Substance-over-form approach, cont’d

• The Italian Tax Authority rejected the request arguing that the beneficial owner was not the foundation rather the members of the foundation.

• The ECJ confirmed that the foundation was not entitled to the exemption since it did not carry out any business activity just remitting the dividends to its members.
Substance-over-form approach, cont’d

- Bank of Scotland case, Cour Administrative d’Appel de Paris, May 23, 2005, nn. 01PA04068;
- An US company entered into an usufruct agreement with the Bank of Scotland, whereby the latter received dividends of a French company. The French Tax Authority did not refund the withholding tax on dividends, arguing that the US company was the beneficial owner.
Recent OECD developments

➢ The OECD has recently (October 2012) issued a discussion draft (“DD2”) on the “Clarification of the meaning of ‘beneficial owner’ in the OECD Model Tax Convention”.

Recent OECD developments, cont’d

➢ According to the DD2, the decisive elements to be taken into account for the correct interpretation of the “beneficial owner” are:
  • the actual powers and “right to use and enjoy the dividend” that the recipient can exercise;
  • the existence of any constraints or obligations limiting the recipient’s powers and rights.
Comments on the OECD developments

The phrase “right to use and enjoy the dividend” could have unintended effects, for example in the situation of:

- the use of holding companies;
- the payment of a dividend by a subsidiary to its parent;
- the situation of trusts;
- the activities of banks or any type of financial institution;
- joint venture arrangements that require distributions.
THANK YOU

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