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Italy closes ranks on CFC rules

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Giuseppe Alessandro Galeano & Giorgio Orlandini have made a critical analyis in their article on the CFC regime in Italy whilst highlighting crucial issues arising out of the amendments to the CFC rules made in 2009.

I. Premises

Rules on controlled foreign companies (hereinafter "CFC") were enacted in Italy by Law 342 of November, 2, 2000. In particular, Article 1 of Law 342/2000 introduced Article 127-bis (now Article 167) of the Italian Presidential Decree number 917 of 1973 (the Italian Tax Code, hereinafter "TUIR"): the discipline aimed at contrasting the tendency of companies' constituting in tax havens in order to avoid ordinary Italian taxation. Recently, Italian CFC rules have been amended by Article 13, Law Decree no. 78 of July 1, 2009[1].

Scope of the present article is to summarise CFC discipline, both identifying the main amendments consequent to Law Decree 78/2009 and, in consideration of the absence of any related Financial Administration's interpretation, highlighting the potential critical issues.

II. CFC rules before Law no. 102/2009

Italian CFC rules are mainly contained in Article 167 TUIR and implemented by legislation of Ministerial Decree no. 429 of November 21, 2001, containing the "black list" countries.

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According to the CFC rules, all revenues made by controlled companies of Italian entities, located in countries considered as tax havens or with a low tax rate, are imputed to the shareholders or partners resident in Italy and taxed in their hands, even if the profits are not distributed as dividends (the so called *fiscal transparency*).

Profits realised in "black list" countries are deemed to be "Italian profits" if:

- The resident individual or company controls, directly or indirectly, even through trust companies or interposed third person, a foreign entity; and
- The foreign entity is resident in a country listed in the "black list" provided for by Ministerial Decree of November 21, 2001[2].

As it concerns, it should be pointed out that the 2008 Italian Budget Law, through the inclusion of the new Article 168-bis TUIR, provided for the issuance of a decree by the Italian Ministry of Economy and Finance, containing two different white lists aimed at replacing the "negative" listing contained in the existing black lists. The criteria for distinguishing and categorising foreign countries are then about to be overturned: from the mention of "bad" countries there is a shift to the identification of "virtuous" countries, whose level of taxation is similar to Italy's and/or "friendly" countries and which allow for an adequate exchange of information with Italian Inland Revenue.

In detail, the new Article 168-bis prescribes the following:

- A white list in charge of identifying countries and territories that allow for the exchange of information with Italy; and
- A white list in charge of identifying countries or territories that allow for an exchange of information with Italy and, at the same time, have a level of taxation that is not significantly lower than Italy's one.

Pending the definition of the white lists, the previous black list approach continues to apply[3].

CFC rules apply both to individuals and companies, exercising or not an entrepreneurial business[4], satisfying the following two requirements: being resident for tax purposes in Italy and controlling a company resident in a country considered as a "tax haven".

"Control" is defined with reference to Article 2359 of the Italian Civil Code, under which a company is deemed to be controlled if:

- Another company holds, directly or indirectly, the majority of the votes at shareholders' meeting;
- Another company holds, directly or indirectly, sufficient votes as to exert a decisive influence in the shareholders' meeting; or
- The company operates under the domain influence of another company due to a special agreement relationship.

CFC rules are also applicable where an Italian entity directly or indirectly holds 20 percent or more of the "black list" foreign company's capital (Art. 168 TUIR).

Profits of the CFC are attributed to the Italian controlling company on the last day of foreign entity's financial year. Income is computed applying the Italian tax provision and taxed separately (i.e. CFC income cannot be offset with Italian tax losses) at the average tax rate. The average tax rate cannot be lower than 27 percent.

Dividends subsequently distributed by the foreign company are taxable only up to the amount exceeding the income already taxed in the hands of the Italian controlling entity under the CFC rules.

Previous to the implementation of Law August 3, 2009, number 102 CFC rules' application could be avoided in case the taxpayers could demonstrate, alternatively, that[5]:

i. CFC effectively carried on actual industrial or commercial activities as its main business activities in the black list jurisdiction (Article 167, paragraph 5, letter a) of TUIR); or
ii. The participation in the CFC was not aimed at allocating income in states or territories with a privileged tax jurisdiction.

> "Ruling request has to be sent before the taxpayer decides whether to apply or avoid CFC rules..."

Still the (i) and (ii) exemptions[6] (the so called "safe harbour" rules) operate autonomously and independently: in order to give them the related evidence, Italian resident entity must apply for a tax ruling in advance claiming the non-application of the CFC provisions[7].

Ruling request has to be sent before the taxpayer decides whether to apply or avoid CFC rules: the Financial Administration has clarified[8] that the "previous ruling requirement" might be considered as satisfied if, for example, the ruling request is submitted within the annual tax return, supported by necessary evidence satisfying the non-application of the CFC rules'

Tax authorities must reply within 120 days of the request[9]: the motivated interpretation provided by the Financial Administration, binds the tax authorities only to the applicant and in relation with the request issued.

In fact, once the Financial Administration provides the taxpayer with a positive interpretation, in terms of defining the participation in the CFC as not aimed at benefiting from any tax advantages, the Financial Administration itself cannot proceed with the issuing of an adverse assessment to the taxpayer in relation with the same circumstance.

III. CFC rules amended by Law no.102/2009

Scope of Law Decree No. 78 of July 1, 2009 was to guarantee the substantial effectiveness of non-resident controlled and affiliated companies.

The CFC rules' main amendments aim at recapturing tax advantages achieved through international tax arbitrage. The amendments shall be summarised as follows:

- Squeezing the first "safe harbour" rule (see point i. preventing the application of the CFC rules to the foreign companies which predominantly carry on, as their principal business purpose, an actual industrial or commercial activity in the foreign local market;
- Lifting the same safe harbour rule for companies deriving mostly passive income or income from intra-group services' supply;
- Applying the CFC rules to foreign companies wherever established;
- Deriving mostly passive income or income from intra-group services supply;
- Subject to an effective taxation in the foreign country less than 50 percent of the level of taxation that would be applicable in Italy.

A. The amendments to the safe harbour rule

Italian resident taxpayers have to demonstrate that the business of the non-resident controlled company is effectively carried out in the foreign country.

As a consequence, the mere ownership of a suitable operating structure in the foreign country itself[10] constitutes a necessary, but not sufficient condition as to avoid CFC rules.

CFC might then implement a strong connection between its activities and the market of the country or territory of establishment: as it concerns, strong connection shall be interpreted as a deep economic and social connection with the foreign country, thus giving further evidence to CFC's aim at actively and permanently participating to the foreign country's economic life.

According to Financial Administration's praxis[11], local market of reference might not coincide with the geographical borders of the establishment's country, but should be widened with reference to substantial economic, political and strategic CFC's relations[12].

Therefore, in consideration of the anti-avoidance purposes of the disposition in hand, it may be assumed that, in order to benefit from CFC rules exemption, resident taxpayers will need to justify the real economic reasons based on which the CFC has carried out its activities in the 'tax haven' resident country.

Moreover, according to new Article 167, TUIR, paragraph 5, letter a), if the non-resident controlled entity is a bank, a financial or insurance institution, its substantial involvement in the economic foreign system may be demonstrated proving that the majority of the assets, liabilities or revenues are generated in the foreign country.

Therefore, in order to benefit from the exemption in hand, resident taxpayers might prove that more than 50 percent of the funds raised, of the financial resources invested and of the income realised are derived from the foreign country.

As previously stated, the chance of giving evidence of an actual industrial or commercial activity as to benefit from CFC's rules avoidance does not operate if more than 50 percent of the revenues of the non-resident controlled entity comes from either:

- The administration, detention or investments in securities, shares, receivables or other financial activities; or
- The transfer or licensing of intellectual property of an industrial, literary or artistic nature; or
- The supply of intra-group services, including financial services.

As a consequence, the exemption as to benefit from CFC's rules avoidance does not operate if the controlled foreign company results into being a passive income company, exercising an economic activity consisting of mere detention and management of fixed assets and intangibles.

The provision is meant to penalise companies established in a friendly tax jurisdiction and earning mostly passive income or income from the supply of intra-group services.

In order to avoid CFC rules, Italian resident companies will thus only have the chance of demonstrating that the participation in the CFC is not aimed at allocating income in states or territories with a privileged tax jurisdiction.

As it concerns, according to Article 5, paragraph 3, Ministerial Decree dated November 21,' 2001 number 429, the over mentioned requirement might be considered as satisfied if revenues made by the non-resident CFC have been generated to an extent of at least 75 percent in a country not considered as tax haven and provided that it has been taxed in the country at a normal tax rate.

B. CFC rules to non– tax havens controlled companies

Pursuant to new Article 167 TUIR, paragraph 8-*bis*, the application of CFC rules might operate also with reference to controlled[13] companies located in states or territories other than those having privileged tax regimes.

The provision occurs if, jointly:

1. The effective tax burden borne by the foreign entity is lower than 50 percent of the tax burden the entity would have borne if it were resident in Italy; and
2. The foreign company derives more that 50 percent of its profits from:
   - Managing, holding or investment in securities, shares, receivables or other financial assets; or
   - The transfer or licensing of intellectual property of an industrial, literary or artistic nature; or
   - The supply of intra-group services, including financial services.

As far as condition (1) is concerned, pursuant to the covering report to Law Decree No. 78 of July 1, 2009, it seems necessary to refer, with regard to tax burden terms of comparison, to the effective tax rate applied and not to the nominal corporate income rate.

Nevertheless, the CFC rules do not operate[14] in case the taxpayer, through a tax ruling in advance, may demonstrate that the foreign company does not constitute an artificial arrangement, aimed at obtaining an undue tax benefit.

Finally, the term 'artificial arrangement' might be considered as referring to a not actual establishment intended to carry on genuine economic activities in the host country.

It should be further pointed out that the term in hand derives from the European Court of Justice decision in the *Cadbury Schweppes* case *(C-196/04)* where CFC rules are declared applicable to companies resident in Member States but only if CFCs represent *"wholly artificial arrangements intended to circumvent national law"*.

In particular, as asked to consider whether CFC legislation is compatible with the provisions of the treaty on freedom of establishment (Articles 43 and 48 EC), the Court pointed out that a national measure restricting freedom of establishment may be justified only where it specifically relates to wholly artificial arrangements aimed at circumventing the application of the legislation of the Member State concerned and does not go beyond what is necessary to achieve that purpose[15]. As a matter of fact, the choice of referring to the term 'artificial arrangement' undoubtedly reflects the Italian Government's aim at complying with EU tax principles.

IV. Possible open issues related to Law 102/2009 amendment

As far as the amendments to the safe harbour rule are concerned, a notable critical issue stands in the provision according to which the chance of giving evidence

of an actual industrial or commercial activity, as to benefit from CFC's rules avoidance, does not operate if more than 50 percent of the revenues of the CFC comes from the administration, detention or investments in securities, shares, receivables or other financial activities. In fact, such provision might considerably damage financial institutions groups, whose primary business consists in the financial assets' management itself.

As a consequence, an official clarification seems to be needed, although the new Article 167 TUIR[16], provides that through the provision, by proving whether a CFC is a bank or an insurance institution, it shall be exempted by proving that the majority of the assets, liabilities or revenues are generated in the foreign country and might exclude automatically, financial institutions, CFCs from the mentioned revenues' threshold test.

Concerning CFC rules, to no–tax havens controlled companies [17], and in particular the provision according to which the effective tax burden borne by the foreign entity shall be lower than 50 percent of the tax burden, the entity would have borne if it were resident in Italy, the financial administration will be required to clarify whether both Italian corporate taxes (IRES and IRAP[18]) shall be required to be taken into consideration, in computing the effective tax rate.

Without considering specific provisions affecting the taxable amount of certain items (such as the participation exemption regime) and having regard only to the ordinary taxable income, the new provision may affect companies whose actual tax rate is below 13.75 percent. This provision could be an issue in case of companies resident in EU Countries like Ireland[19] or Cyprus[20].

Investments in those countries being discouraged in relation with CFC tax discipline, unless the taxpayer demonstrates that the foreign company does not constitute an artificial arrangement aimed at obtaining an undue tax benefit, potential incompatibilities between Italian CFC rules and the treaty on freedom of establishment (Articles 43 and 48 EC) might arise

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NOTES

[1] Converted in Law number 102 of August 3, 2009, effective from January 1, 2010.

[2] Pursuant to Article 1 Decree of November 21, 2001 black list countries are: "*Alderney (Isole del Canale), Andorra, Anguilla, Antille Olandesi, Aruba, Bahamas, Barbados, Barbuda, Belize, Bermuda, Brunei, Cipro, Filippine, Gibilterra, Gibuti (ex Afar e Issas), Grenada, Guatemala, Guernsey (Isole del Canale), Herm (Isole del Canale), Hong Kong, Isola di Man, Isole Cayman, Isole Cook, Isole Marshall, Isole Turks e Caicos, Isole Vergini britanniche, Isole Vergini statunitensi, Jersey (Isole del Canale), Kiribati (ex Isole Gilbert), Libano, Liberia, Liechtenstein, Macao, Maldive, Malesia, Montserrat, Nauru, Niue, Nuova Caledonia, Oman, Polinesia francese, Saint Kitts e Nevis, Salomone, Samoa, Saint Lucia, Saint Vincent e Grenadine, Sant'Elena, Sark (Isole del Canale), Seychelles, Singapore, Tonga, Tuvalu (ex Isole Ellice), Vanuatu*".
With reference to specific companies' categories: Monaco, South Korea, Luxembourg, Malta, Mauritius and Switzerland.

[3] See Article 1, paragraph 88, Law December 24, 2007 no. 244 - effective on January 1, 2008

[4] According to Article 2082 of Italian Civil Code: "An enterpriser is a person who engages professionally in an

[5] See Article 167 TUIR, paragraph 5

[6] Known as "first exemption" and "second exemption"

[7] The ruling procedure is regulated by Article 11 of Law 212 of July 27, 2000 (Taxpayers' Bill of Rights).

[8] See Circular dated May 31, 2001, number 50.

[9] In case of no reply, the interpretation provided by the taxpayer is considered accepted.

[10] As requested by Article 5, paragraph 3, Ministerial Decree November 21, 2001, number 429.

[11] See Resolution May 26, 2009, number 128/E.

[12] The so called 'CFC area of influence'.

[13] Note that, pursuant to Article 168 TUIR, paragraph 1, the provision in hand does not operate towards affiliated companies.

[14] Pursuant to article 167 TUIR, paragraph 8-*ter* TUIR.

[15] *C-196/04 - Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue*judgment of 12.9.2006-European Commission Legal Service.

[16] See paragraph 3.A.

[17] See paragraph 3.B.

[18] Please note that IRES represents the general corporate income tax - rate 27.5%, while IRAP constitutes the regional tax on productive activities – rate 3.9%.

[19] Tax rate - 12.5% for trading income

[20] Corporate tax rate - 10%

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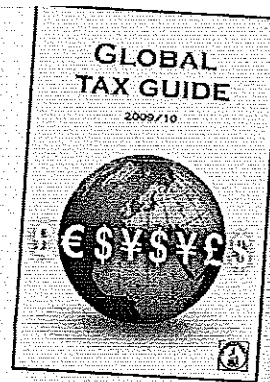

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