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Italy: guidelines on Italian CFC rules

The Law Decree No. 78 of July 1, 2009 (converted, with amendments, by the Law No. 102 of August 3, 2009) introduced relevant changes to the Italian CFC rules with effect starting from, as far as calendar year companies are concerned, 2010.

Under the rules in effect **before** the Law Decree No. 78, the income of a CFC was attributed to the Italian controlling person in proportion to its participation only if the CFC was located in a black-list country (hereinafter "Black-list CFCs") and unless it was proved by mean of a tax ruling that either:

- the foreign company actually carried on a commercial activity ("commercial exception"); or
- the participation in the foreign company was not owned with the aim of allocating profits in a favourable tax jurisdiction ("anti-abusive exception").

The **new rules** changed the "commercial exception" to require that the main business of the CFC must be carried out in the "market" of the state or territory in which the CFC is established.
In addition, pursuant to the new rules, such exception cannot be claimed if more than 50% of the CFC's income is "passive", i.e., stems from either of the following activities:

- the management, holding or investment in securities, participations, receivables or other financial investments;
- the disposition or exploitation of intangibles relating to industrial, artistic or literary rights;
- services (including financial services) carried out for entities belonging to the same group.

In addition, the **new rules** extend the application of the regime to foreign persons located in white-list countries (hereinafter White-list CFCs) if both:

- more than 50% of the foreign company's income is "passive", i.e., stems from the above-mentioned activities; and
- the foreign company's effective tax rate is lower than 50% of the tax rate that would have been applied if it was tax resident in Italy.

The extension is avoided by filing a tax ruling proving that the foreign entity does not represent an artificial structure aimed at achieving an undue tax advantage.

Recent developments

With Circular Letter No. 51 of 6 October 2010, the Italian tax authorities commented on new CFC rules. Below is a summary of the most important comments contained therein.

1. Black-list CFCs

1.1 The commercial exception

Market link

Pursuant to the new CFC rules, Italian taxpayers who intend to invoke the commercial exception are now required to prove that the business activity carried out by the CFC is permanently and continuously connected with the local market, i.e, the local market is the place where goods and/or services are acquired and/or sold by the CFC. The law explicitly provides that as far as banks, financial institutions and insurance companies are concerned, the link is deemed to exist when the majority of the funds and/or investments originates from the local market.

The Circular Letter No. 51 additionally clarifies that the local market shall be deemed to include the contiguous geographic area connected to the CFC country by mean of economic, political, geographic or strategic links.

More than 50% of passive income

The commercial exception cannot be claimed for CFCs with more than 50% of "passive" income. However, the tax authorities clarify that the Italian controlling person may still claim this exception by filing an advance ruling additionally proving the absence of any tax avoidance purpose (e.g., foreign persons operating in a pure non-Italian context).

In addition, the Circular Letter No. 51 highlights that, in order to compute the 50% threshold, the overall proceeds (including extraordinary profits) accounted in the P&L account should be taken into consideration and the calculation should be carried out each year. The documentation should be properly recorded and provided to the Italian tax authorities upon request.

1.2 The anti-abusive exception

The Circular Letter No. 51 points out that the said exception might be claimed, inter alia, by CFCs whose overall income is produced for at least 75% in a non-black listed country. This would be the case, e.g., of a foreign company with a permanent establishment located in a non-black-listed country, or owning in such a country fixed assets whose incomes are ordinarily taxed therein. This would also be the case, e.g., of a foreign company that has its place of effective management in a non-black-list country so as to acquire tax residence and being taxed therein or of a foreign person incorporated in a non-black-listed country that owns a permanent establishment in a black-list country that is entirely subject to tax in its state of residence.

In general terms, the said exception can be claimed when the effective tax rate suffered by the foreign entity is fair compared to the actual tax rate that it would have suffered if resident in Italy for tax purposes.

In addition, considering that black-listed countries are those, inter alia, that does not allow a sufficient exchange of information, for the purpose of claiming such exception the taxpayer should also demonstrate that the profits are systematically distributed. As a matter of fact, according to the Italian tax authorities, the systematic distribution of dividends is a mean for both demonstrate that the structure was not created for anti-avoidance purposes and to display the relevant data.

2. White-list CFCs

2.1 Definition

More than 50% of passive income

The same considerations made above apply.

Effective tax rate

The theoretical tax must be calculated by applying the Italian corporate tax rate (IRES – 27.5%) to the foreign company's P&L account, as adjusted, upwards or downwards, according to Italian tax law provisions.

Furthermore, as to the comparison between the effective tax and the theoretical tax, the following rules should apply:

- the foreign person should be considered on a stand alone basis (i.e., foreign tax group regimes should be disregarded);
- foreign tax losses generated prior to the entry into force of the new regime should not be taken into consideration;
- the Italian Regional tax (IRAP) is immaterial.

The comparison must be carried out each year. The documentation should be properly recorded and provided to the Italian tax authorities upon request.

With respect to "pure holding" entities (i.e., persons which typically derive passive income in the form of dividends and capital gains), the Circular Letter No. 51 points out that, in the context of the aforesaid comparison, the Italian 95% participation exemption regime providing for an effective tax rate of 1.375% (i.e. 27.5% applied on 5% of the dividend or capital gain) is substantially equivalent to the 100% participation exemption regime granted by other jurisdictions. Therefore, pure holding entities should not suffer any adverse implication due to the application of the CFC regime. However, the Italian tax authorities clarified that an advance tax ruling should be filed to confirm facts and circumstances.

2.2 The lack of artificial structure exception

As indicated above the extension to White-list CFCs does not apply when the foreign person is not an artificial arrangement aimed at achieving an undue tax advantage.

The Circular Letter No. 51 explains that the concept is consistent with the one used by the European Court of Justice in the ruling No. C-194/06 Cadhbury-Schweppes of November 12, 2006.
In addition, the Italian tax authorities make clear that taxpayers may prove the substance of the

structure by making reference to the non-exhaustive list of parameters mentioned in the EU Counsel resolution of June 8, 2010 on coordination of the Controlled Foreign Corporation and thin capitalization rules within the European Union.

Pursuant to the resolution, some of the indicators suggesting that profits may have been artificially diverted to a CFC includes in particular the following:

- there are insufficiently valid economic or commercial reasons for the profit attribution, which therefore does not reflect economic reality;
- incorporation does not essentially correspond with an actual establishment intended to carry on genuine economic activities;
- there is no proportionate correlation between the activities apparently carried on by the CFC and the extent to which it physically exists in terms of premises, staff and equipment;
- the non-resident company is overcapitalised, it has significantly more capital than it needs to carry on its activity;
- the taxpayer has entered into arrangements which are devoid of economic reality, serve little or no business purpose or which might be contrary to general business interests, if not entered into for the purpose of avoiding tax.

3. CFC rulings

With respect to the timing, the Circular Letter No. 51 confirms that the Italian tax authorities must respond within 120 days from the filing of the application, unless addition documentation is requested. After such term a silent consent is presumed.
Additionally, it is clarified that the request is made in due time if the response is received within the deadline for the filing of the tax return (September 30, as far as calendar year companies are concerned). Advance rulings are mandatory but the taxpayer is not obliged to follow the answer given by the Italian tax authorities. In the latter case, the taxpayer can support its position in the course of tax audits or litigation proceedings.

How we can help

CMS has a network of tax specialists that can help you in submitting tax rulings before the Italian tax authorities.
In addition CMS has a litigation department specialized in supporting the defense of tax audits at all levels, including the Italian Supreme Court and the European Court of Justice.

For further information on this tax analysis and thought, please contact:

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