# Italy: New CFC Legislation

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## 1. Premise

New provisions concerning the taxation of income generated by Controlled Foreign Companies (CFC Legislation) have recently been introduced.

Indeed, two different bills of law were presented to the Parliament on 15 November 1999 and 15 March 2000. The latter was approved, with certain amendments, by the Senate on 5 July 2000 and by the Chamber of Deputies on 4 October 2000 and was finally included in the Law N. 342 of 21 November 2000, which has been published in the Official Gazette N. 276 of 25 November 2000.

The aim of the provisions is to tax at the Italian shareholders level the income earned by foreign related entities located in low-tax countries (CFC entities), regardless of the actual dividend distribution. In other words, income earned by the foreign CFC entity will be imputed to the Italian shareholder in proportion to the participation held and taxed at the Italian ordinary income tax rates starting from the end of the tax year in which it is accrued by the foreign entity.

The following analysis summarizes the main contents of the CFC legislation which introduces major changes in the Italian tax system. The adoption of such measures is consistent with the OECD recommendations included in the 1998 Report concerning harmful tax competition and with the EU Code of Conduct.

## 2. Scope of the CFC legislation

### A. Personal requirements

The CFC provisions apply to the following taxpayers that are tax resident in Italy:

- individuals;
- informal, general and limited partnerships and entities treated as such for tax purposes (Art. 5 of Italian Income Taxes Consolidated Text contained in Presidential Decree no. 917 of 22 December 1986 (IITCT));
- companies (Art. 87(a) of IITCT);
- public and private commercial bodies (Art. 87(b) of IITCT);
- public and private non-commercial bodies (Art. 87(c) of IITCT).

Italian permanent establishments of non-resident persons (Art. 87(d) of IITCT) are excluded from the CFC legislation.

The CFC provisions apply to income earned by the following entities located in low tax jurisdictions:

- enterprises;
- companies;
- other bodies.

The provision refers to the general concept of 'location' in a low tax jurisdiction, thus including in its scope all entities subject to low tax regimes, irrespective of and without limitation to the definition of residence for tax purposes in said jurisdictions. Furthermore, permanent establishments located in low tax jurisdictions of non-Italian entities are also included in the scope of the new legislation even if the head office is excluded from same. However, if the branch income is subject to tax at the head office level, the taxpayer may try to avoid the application of the CFC legislation by proving that the holding of the participation in that entity does not have the main purpose of locating the income in a low tax jurisdiction.[1]

### B. Low tax jurisdictions

Low tax jurisdictions are defined as the countries and territories which benefit from a preferential tax regime and are included in the 'black list' to be published by the Ministry of Finance on the basis of the following criteria:

- the taxation is substantially lower than it is in Italy;
- the lack of appropriate exchange of information;[2]

**Notes**

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1 See section 2.D of this article for further details.

2 Countries with which the exchange of information is available are listed by the Decree of the Ministry of Finance of 4 September 1996, enacted and subsequently amended for the purposes of the withholding tax exemption on bonds interest payments: Algeria, Argentina, Armenia, Australia, Austria, Azerbaijan, Belgium, Bielorussia, Brazil, Bulgaria, Canada, China, Croatia, Czech Republic, Denmark, Ecuador, Egypt, Finland, France, Georgia, Germany, Greece, Hungary, India, Indonesia, Ireland, Israel, Ivory Coast, Japan, Kazakhstan, Kirghisistan, Kuwait, Lithuania, Luxembourg, Macedonia, Malta, Mauritius, Mexico, Morocco, Netherlands, New Zealand, Norway, Pakistan, Philippines, Poland, Portugal, Romania, Russia, Singapore, Slovak Republic, Slovenia, South Africa, South Korea, Spain, Sri Lanka, Sweden, Tadzhikistan, Tanzania, Thailand, Trinidad and Tobago, Tunisia, Turkey, Turkmenistan, Ukraine, United Arab Emirates, United Kingdom, USA, Uzbekistan, Venezuela, Vietnam, Yugoslavia, Zambia.

- other equivalent conditions.[3]

Some doubts might arise with respect to such criterion considering that it does not seem clear which conditions may be 'equivalent' to the lower level of taxation and the lack of appropriate exchange of information and it gives the Ministry of Finance the chance to include in the black list countries and territories on the basis of other criteria which are not expressly indicated by the law.

Even if the new black list of tax havens has not yet been published, one may expect that it will be more detailed and extensive than the one presently in force, thus covering a broader number of low tax countries and regimes. Indeed, although the list of countries and territories qualifying for the CFC legislation might differ from the current black list of tax havens, presently black-listed countries are very likely to be included in the new list (which probably will add others), since the criteria provided for by the law are generally met where the presently black-listed countries are concerned.

The above conditions do not expressly exclude from tax havens EU countries, thus enabling the Ministry of Finance to include them in the black list without the need to obtain an amendment to the law by Parliament.

Finally, one should note that, even if the law refers to countries and territories (which are geographical concepts), the Report of the Ministry of Finance to the bill of law clarifies that reference might be made to special low tax regimes not granted with reference to specific territories but to specific categories of taxpayers, income or situations.

### C. The level of participation

The CFC legislation applies if the Italian shareholder has the control, as defined by the Italian Civil Code,[4] of the non-resident entity.[5] Foreign entities in which the resident taxpayer does not exercise the control, as above defined, are therefore excluded from the scope of the new CFC legislation, even if located in low tax jurisdictions. That exclusion is of particular relevance for Italian taxpayers entering into joint ventures with foreign partners which provide for the minority participation in companies or entities located in low tax jurisdictions. The participation might be held:

- directly;
- indirectly;
- by means of trust companies or interposed persons.

The law does not provide any indication about the precise moment in time which the participation test must refer to, i.e. whether it is the end of the tax year, the greater part of the tax year (e.g. 183 days) or any time (e.g. a single day) during the tax year.

Furthermore, the provision does not clarify how to determine the portion of income of the tax haven entity that should be taxed at the Italian shareholder's level in case the participation was not held for the entire tax year. A rational criterion might be to impute the income proportionally to the days of holding during each tax period.

### D. Exclusions

The law provides for two cases of exclusion from the scope of the CFC legislation. The first applies if the Italian controlling entity gives evidence that the CFC entity carries on an actual commercial or industrial activity as its main activity within the country or territory in which it is based.[6] An example of structures benefiting from that exclusion might refer to companies acting as local wholesale or retail distributors of the Group's products within the country where they are located. The second case of exclusion applies if the Italian controlling entity may prove that the holding of the participation in the CFC entity does not have the main effect of locating the income in a low tax jurisdiction.[7] An example of a similar situation may probably be found in a company having its legal seat in a low tax jurisdiction which derives almost all of its income from a branch located and taxed in a high tax jurisdiction[8]. On the other hand, a company located and subject to tax in a high tax jurisdiction having a branch in a low tax jurisdiction whose profits are taxed at the head office level might also qualify for the exclusion, as well as a company located in a low tax jurisdiction indirectly controlled through an inter-

**Notes**

3 The bill of law of 15 November 1999 also included the lack of international treaties. Said criterion is not repealed by the current text.

4 According to Art. 2359 of the Italian Civil Code, the 'control' is deemed to exist if the controlling entity:

- holds more than 50 per cent of the voting rights in the ordinary shareholders' meeting of the controlled company;
- holds enough voting rights in order to exercise a 'prevailing' influence in the ordinary shareholders' meeting of the controlled company;
- has the right to exercise a 'prevailing' influence on the controlled company due to special contractual arrangements with the latter.

5 According to the former bill of law of 15 November 1999, the CFC legislation applied when the Italian shareholder owned a participation equal to at least to 25 per cent of the non-resident CFC entity or having a value equal to at least ITL15 billion. The bill of law did not provide any specific criterion to determine which 'value' was to be taken into account, i.e. historical acquisition value, value in the current financial statements, current tax value, etc. and if subsequent possible write-off of the participation were of relevance.

6 The bill of law originally presented to the Parliament referred to the market, rather than the country or territory, in which the CFC entity was based. The Chambers of Deputies changed the wording of the provision, thus solving the possible issues related to the interpretation of the concept of market.

7 The Parliamentary report on the bill of law refers to the intention to exclude from the scope of the CFC legislation the multinationals which demonstrate to suffer a fair taxation abroad, thus supporting the conclusion that their location in low tax jurisdictions is justified by their operating structure, rather than the tax avoidance.

8 In this respect, see the ministerial letter N-207/E of 16 November 2000.

mediate foreign holding company subject to the CFC legislation in force in its country of residence.

While all the above examples seem to be in line with the wording of the law, reference will have to be made to the prevailing interpretation by the Italian tax authorities, case law and doctrine in order to assess the conditions to be met in all different situations to benefit from the exclusion from the scope of the CFC legislation. In order to benefit from the above exclusions, the taxpayer must obtain an advance ruling from the Italian tax authorities.[9]

### *E. Entry into force*

The CFC provisions should enter into force as of the tax year subsequent to the year in which the black list mentioned above will be published in the *Official Gazette* by the Ministry of Finance.

## 3. Tax implications

The application of the CFC legislation will imply that income earned by CFC entities, irrespective of its distribution and in proportion to the participation held, is included in the Italian controlling entity's taxable income and be subject to tax therein as of the end of the tax year of the CFC entity.

According to the Parliamentary report to the bill of law, if the control interest is indirectly reached through more than one resident entity, the income of the CFC entity must be allocated to each of them in proportion to the shares respectively held. This interpretation seems to imply that in case of indirect ownership through Italian sub-holdings, the CFC income is proportionally allocated and taxed only once at the lower Italian sub-holding level, thus avoiding the risk of double taxation at the higher levels. The CFC income allocated to the Italian controlling entity is determined according to the provisions of IITCT applicable to business income,[10] dividends received by Italian corporate shareholders from foreign affiliated companies, loss carry-forward, banks, finance and insurance companies. Same income is subject to separate taxation at the same average rate applicable to the ordinary income of the resident taxpayer, but in no case lower than 27 per cent.

Indeed, since Italian provisions for the determination of business income are quite complex and specific[11] and generally require data and other information which may not be entirely obtained from the financial statements, the CFC legislation might be difficult to apply on the basis of the foreign entities' financial statements only. A critical issue, therefore, arises in connection with the documentation and bookkeeping that the Italian tax authorities might request to assess the correct application of the domestic provisions to the income derived by the foreign entities.

In the case where the non-resident CFC entity subsequently distributes dividends, the distribution should be taxed at the resident shareholder's level. However, the portion of the dividends (if any) corresponding to the income of the non-resident person which has already been included in the taxable income of the resident shareholder under the CFC legislation, even during prior tax years, should not be taxed upon actual distribution. The provision does not specify if, in case of indirect ownership, said dividends are taxed upon distribution by the CFC entity to the intermediate holding (even if not received by the Italian controlling taxpayer) or upon redistribution of same to the Italian shareholder by the intermediate holding structure. In the latter case, however, additional issues would arise in connection with the identification of the source of dividends distributed to the Italian taxpayer by the intermediate holding, i.e. if they derive from dividends distributed by the CFC entity or by other non-CFC income.

### *A. Loss carry-forward*

The law expressly states that Italian income tax provisions on tax loss carry-forward contained in Art. 102 of IITCT are applicable to CFC income.[12] However, considering that, as mentioned above, the CFC income is subject to separate taxation at the Italian controlling entity's level, the question arises of what losses may be used to offset the CFC income.

The Parliamentary report on the bill of law specifies that the separate taxation implies that income derived from each CFC entity is calculated and taxed autonomously, even if located in the same country. That specification implies that losses derived from a CFC entity may not be utilized to offset income derived from a different CFC entity as they refer to separate 'baskets'.

The separate taxation should also entail the impossibility of offsetting the Italian income of the controlling taxpayer with losses incurred by the CFC entity as well as the impossibility of offsetting foreign CFC income with the losses incurred by the Italian controlling taxpayer either in the same or in previous years. As a result of this strict interpretation of the law,

**Notes**

[9] The necessity of obtaining the advance ruling was introduced by the Chamber of Deputies, while the previous bill of law provided it as a mere possibility for the taxpayer.

[10] Two relevant exceptions to such general principle are provided for by the law, i.e. the impossibility of deferring the capital gains taxation over five years and to deduct accelerated depreciation on tangible fixed assets.

[11] According to Art. 52 of IITCT, the business income is determined on the basis of the income or loss shown in the profit and loss account, recording all of the adjustments (increases and decreases) provided for by the tax law.

[12] The same possibility was not included in the former bill of law of 15 November 1999.

one may conclude that income accrued by the foreign CFC entity is taxed in Italy on an accrual basis, while losses incurred may only be deducted from income of the same CFC entity during the subsequent years, not exceeding the fifth according to the provisions of Art. 102 of IITCT.

### *B. Foreign tax credit*

The law provides for the possibility of benefiting from the foreign tax credit[13] under Art. 15 of IITCT[14] for:

- taxes paid abroad by the CFC entities on income included in the Italian shareholder's taxable income, and
- taxes paid abroad by the Italian shareholder on dividends received (e.g. the applicable withholding taxes).

However, if said dividends are not taxable upon receipt due to the prior taxation of the distributed income under the CFC provisions, the foreign tax credit is limited to the amount of taxes which were paid on that income, net of the tax credit already applied under the first point above.

The possibility of benefiting from the above-mentioned foreign tax credit gives rise to the following issues in case of indirect holding structures involving a chain of foreign sub-holdings.

- When the intermediate holding companies reside in non-tax haven countries providing for their own CFC legislation, the income earned by the CFC entity might be taxed in each country, although at different rates, according to its own CFC legislation. The wording of the law does not seem to allow the possibility of benefiting from the foreign tax credit for the taxes paid at the foreign sub-holding level due to the local CFC applicable legislation. As mentioned above, in this situation the taxpayer should probably try to demonstrate that the holding of the participation in the CFC entity does not have the main effect of locating the income in a low tax jurisdiction in order to qualify for the exclusion from the application of the Italian CFC legislation based on the argument that a similar regulation already applied abroad with the consequence of taxing the CFC income.
- When the intermediate holding companies reside in non-tax haven countries and, even if not subject to any CFC legislation, do not benefit from any participation exemption, a double taxation issue may arise due to the fact that the income earned by the CFC entity might be taxed in Italy under the proposed CFC legislation and in the country of residence of the intermediate holding companies upon its distribution.
- When the holding structure involves a chain of more than one CFC entities, same income might trigger double taxation when distributed to the intermediate CFC entities.

## 4. The non-deductibility of costs charged by tax haven entities

Under the current Italian legislation, costs incurred in relation to transactions with tax haven-related entities are not tax deductible unless the taxpayer gives evidence that the tax haven entity actually carries on an effective business activity or that the transactions carried out have an effective business purpose and have been actually and properly executed. The bill of law provides for the amendment of these rules in order to exclude the deductibility of costs incurred in connection with transactions performed with any tax haven entity, even if not related.[15]

The law also sets forth the change of evidence to be given by the Italian taxpayer to be eligible for the tax deductibility of costs paid. Indeed, according to the law, the Italian taxpayer will have to demonstrate that the tax haven entity mainly carries on an effective commercial or industrial activity within the market of the country in which it is based. Costs and other negative components deducted in connection with transactions effected with tax haven entities will have to be separately evidenced in the Italian income tax return.

Finally, the law establishes that the above limitations to the deductibility of costs and expenses related to transactions with tax havens entities do not apply to entities included within the scope of the new CFC legislation.

**Notes**

[13] The same possibility was not included in the former bill of law of 15 November 1999.

[14] Art. 15 of IITCT provides that, in case foreign source items of income are included in the overall taxable income of a resident person, foreign tax definitively paid on same items of income may be deducted against Italian net tax liability to the extent of the portion of same tax liability corresponding to the ratio between the foreign source items of income and the overall taxable income, not taking into account losses carried forward.

[15] The law modifies the current text of Art. 76, paras. *7bis* and *7ter*, of IITCT. The modified text is the following:

'7-bis. Expenses and other negative items of income deriving from transactions between resident enterprises and enterprises tax resident in countries or territories which are not part of the EU and have a privileged tax system are not tax deductible. Countries and territories which are deemed to have a privileged tax system will be indicated by Decree of Ministry of Finance on the basis of taxation substantially lower than the one in Italy and lack of appropriate exchange of information, or other equivalent criteria.

7-ter. Provisions under paragraph 7-bis shall not apply where the Italian resident enterprises provide evidence that the foreign enterprises carry out mainly an actual industrial or commercial activity in the market of the country where they have their seat. Tax Authorities, before issuing the tax assessment, shall notify to the tax payer appropriate notice granting the possibility to provide same evidence not later than 90 days. Where Tax Authorities deem the provided evidence not proper, they shall provide specific reason in the tax assessment. The deduction of the expenses and other negative items of income in accordance with the preceding paragraph is subject to the separate indication of the deducted amounts in the tax return'.

## 5. The 95 per cent exemption on dividends distributed by non-EU subsidiaries

The law also establishes the extension of the 95 per cent exemption currently applicable to dividends received by Italian Parent companies from EU subsidiaries, which was introduced to implement the EU Parent-Subsidiary Directive (the Directive), to dividends distributed by non-EU subsidiaries resident in countries with which Italy may effect an adequate exchange of information and where they are subject to a tax system similar to the one in force in Italy. Said countries will be identified by a subsequent Decree to be enacted by the Ministry of Finance. The 95 per cent exemption should apply to non-EU dividends received starting from the tax year subsequent to the one in which the latter Decree is published in the Italian *Official Gazette*.

**Notes**

1 The proposal is published in the so-called *Departementsserien* 2000:28, 'Anpassningar på företagsskatteområdet till EG-fördraget' and Regeringens proposition 2000/01:22.