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Italian Proposals Endorsing Internationalization of Financial Enterprises

by Caterina Alagna and Federico Vincenti

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In this article, the authors describe Law No. 23, which includes proposals to enhance the internationalization of financial entities operating in Italy and to revise the tax legislation on cross-border transactions.

Law No. 23, issued March 11, 2014, tasked the Italian government with creating a fairer, more transparent, and growth-oriented tax system.

Under article 12 of the legislation, the Italian government must introduce provisions aimed at minimizing uncertainties related to the determination of income (for Italian income tax purposes) as well as of net production (for regional tax on productive activities purposes). Those provisions are intended to enhance the internationalization of financial entities operating in Italy, in compliance with recommendations by international organizations and the European Union.

Law No. 23 emphasizes the need to revise the tax legislation on cross-border transactions, in particular on issues concerning:

- identification of tax residence;
- regulations for the imputation of income applicable to foreign subsidiaries and associated companies (controlled foreign corporation rules);
- the repatriation regime of dividends originating in low-tax countries;
- the deductibility regime of commercial transaction costs involving entities located in low-tax states;
- the application regime of cross-border tax withholdings;
- regulations governing personnel abroad and cross-border workers;
- the tax regime of permanent establishments abroad as well as of nonresident entities located in Italy; and
- the regime on losses of group companies residing abroad.

Further, as noted in article 6 of the legislation, the need to introduce provisions to optimize relations between tax authorities and taxpayers by means of enhanced forms of communication and cooperation is strongly felt.

From a risk management perspective in particular, tax authorities should provide incentives for larger corporations that adopt suitable corporate risk management tools — that is, fewer requirements, a reduction of any possible penalties, and specific forms of ruling with abridged procedures.

On April 21, during a preliminary review, the Italian Cabinet approved draft legislative decrees to enforce the tax reform at issue:

- the e-transmission of VAT transactions and the control of transfer of assets carried out through e-distributors (e-invoicing);
- provisions for the development of enterprises and their internationalization; and
- provisions regarding certainty of the law and taxpayer relations.

Those draft decrees are subject to the Parliamentary Commission's scrutiny.

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It is worth noting that the dates of a provision's approval and entry into force will play an important role because for many provisions, the effective date of the legislative decree will begin from the tax period in progress. Therefore, should the legislative decree be approved in 2015, various provisions would be deemed effective during the tax period in progress.

Advance Rulings

One of the most important legislation themes concerns the review of tax regulations governing cross-border transactions, which is intended to foster competitiveness in Italian territory so that the country can become a center of attraction for national and foreign enterprises.

Especially in an economy characterized by globalization, the opening of new markets, the growing diffusion of foreign enterprises, and the consequent increase of cross-border exchanges, the Italian Revenue Office must play a supporting role to internationalization, with the goal to reduce any restrictions to cross-border transactions and to create a legislative framework that is as reassuring and transparent as possible for investors.

Further, the Italian government's main objective is to identify specific actions within the framework of international taxation intended to:

- create a milieu in which there is greater certainty, by means of such approaches as eliminating gaps in the domestic system;
- reduce requirements for enterprises and related administrative burdens;
- adjust internal rules to recent rulings issued by the Court of Justice of the European Union; and
- remove any distortions in the system.

One of the aspects drawing special attention involves the advance rulings regime between the Italian tax authorities and international enterprises. The Italian system provides for a similar tool — that is, the so-called international ruling standard, which is a special kind of ruling that grants the opportunity to obtain an advance ruling with the tax authorities on the company's tax treatment of financial and income components.

The international ruling standard is thus intended for international corporations, which the same provision defines as:

- any enterprise residing in the state's territory, which may be qualified as such under applicable income tax rules, and which, either alternatively or jointly:
  - finds itself — vis-à-vis nonresident companies — in one or more of the conditions under the Italian Income Tax Code, article 110, paragraph 7;
  - participates in the assets, funds, or capital of nonresident entities; or
  - has paid to (or received from) nonresident entities any dividends, interests, or royalties;
- any nonresident enterprise exercising its activities in the state's territory through a PE that may qualify as such under income tax provisions.

The provision is aimed at the foregoing enterprises operating internationally and defines with the Italian tax authorities:

- calculation methods of the arm's-length value of transactions in article 110, paragraph 7 of the Italian Income Tax Code (transactions falling under the scope of transfer pricing may also entail cost-sharing agreements as well as business restructurings);
- the application of rules (also treaty sourced) to a material case involving the issue to nonresident entities — that is, nonresident entities' receipt of dividends, interests, royalties, or other income;
- the application of rules (also treaty sourced) to a material case involving the allocation of profits or losses to a PE in Italy of a nonresident entity, or rather to the PE of an enterprise residing in another state; and
- the preliminary assessment of whether the requirements to ascertain the existence of a PE in the state's territory have been met.

In the second edition of the International Ruling Standard Bulletin, dated March 19, 2013, the tax authorities emphasized that recourse to the above provision had increased. Especially noteworthy is the observation that more ruling applications were submitted between 2010 and 2012; 83 applications were filed, well above the 52 applications submitted between 2004 and 2009 (38 applications were filed in 2012 alone).

The draft legislative decree provides for the abrogation of the international ruling standard and the introduction of advance rulings for international enterprises, regulated by article 31-*ter* of Presidential Decree No. 600/1973.

The new tool allows international enterprises to define in advance the various foregoing issues, as already provided under the international ruling standard, and also to define a priori any exit-entry values, in case of residence transfers, under articles 166 and 166-*bis*, respectively, of the Italian Income Tax Code.

An advance ruling is binding on taxpayers and on the tax authorities for the tax period in which the agreement was entered into and for the following four tax periods, save for any significant changes that may supervene in any de facto or *de jure* circumstances for the purposes of the signed agreements and that may derive therefrom.

However, when the agreements follow any agreements entered into with the competent foreign states as a result of the mutual agreement procedures provided

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by double tax treaties, the agreements are binding on the parties on the basis of arrangements agreed upon with the authorities, with the effective date starting from prior tax periods, provided they did not precede the tax period in progress on the date on which the taxpayers submitted the relevant application.

If any de facto or *de jure* circumstances underlying the agreement refer to one or more tax periods preceding the stipulation thereof but not before the tax period in progress on the filing date of the application, the taxpayer has the right (regarding the said tax periods) to claim the retroactive validity of the agreement by adopting a different approach if necessary and resorting to a voluntary regularization provision — that is, filing a supplementary tax return.

The draft legislative decree is meant to provide taxpayers with greater certainty regarding tax matters; as such, the above document also envisages the introduction of rulings for corporations that plan to make new investments in Italy. In particular, an enterprise meaning to invest at least €30 million in the state's territory, which could have a significant and long-term effect on employment, can submit a ruling application to the tax authorities regarding the tax treatment of its investment plan, along with any likely extraordinary operations that may be envisaged for its realization.

The request for a ruling may relate to any and all tax aspects for which the Italian tax authorities are competent, in connection with both the investment plan and the consequent performance of the envisaged economic activity, including any aspects regarding interpretation or application or that may involve prior assessment of any possible abuse or avoidance of the planned transactions.

The minimum investment threshold (€30 million) must be supported by documentation; a business plan indicating investment figures, time frame, and procedures is essential. The investment may also involve the reorganization of enterprises undergoing financial difficulties, should that produce beneficial employment effects. Regarding the time frame for the realization of the investment project, there is no requirement for the forecast investment amount to be achieved in a single tax period, given that the timing provided by the business plan is relevant to that purpose.

The tax authorities' reply shall be formalized in writing within 120 days (and may be extended for 90 days if additional information is required) and shall be binding on the Italian tax authorities for five years (starting from the tax period in progress on the date the application was filed and extending through the four subsequent years). The tacit consent rule applies if the tax authorities do not reply within the established terms.

The tax authorities shall publish a yearly summary of the interpretative positions adopted, which were of general interest. The definition of the application procedures for the ruling is to be resolved by a ministerial decree, which will be followed by a regulation to be issued by the tax authorities' director; the latter is held to identify the competent offices in charge of the relevant replies.

Further Developments

The draft legislative decree includes several new aspects on the theme of international taxation that are expected to have a significant impact on enterprises with international activities working in the Italian territory.

Amendment to the Blacklist Cost Regime

By amending article 110, paragraph 10 of the Italian Income Tax Code, the draft legislative decree would allow taxpayers to deduct expenses within the threshold established by arm's-length values for goods and services purchased in transactions effectively carried out, entered into with resident enterprises, or located in states or territories with low-tax regimes, identified as blacklist countries because of the lack of adequate information exchange.

Therefore, just as for transfer pricing analyses, any remuneration between the parties to the transactions must be assessed to ensure that the transactions fall within the deductibility rationale proposed by the new provisions. Further, the draft legislative decree provides the opportunity to deduct the costs, regardless of the fact that the foreign enterprise may mainly carry out an effective commercial activity.

Amendment to CFC Regulations

The application of the regime for full taxation of dividends sourced from blacklist countries is strictly limited to situations in which participations are directly held in a company located in low-tax states or territories or, in case of indirect participation, for ownership of a controlling participation in an intermediate whitelist company, which in turn earns profits from participating companies in territories with low-tax regimes.

To remove some distortions from the regime, the draft legislative decree would introduce a tax credit in favor of the resident controlling shareholders — that is, to the resident controlled companies — on profits received and on capital gains realized. Further, the requirement to submit a ruling request in order to be exempt from CFC rules, in case of participations held in CFCs, has been repealed and replaced by the option for the controlling entity to file for a ruling to obtain an advance opinion by the tax authorities regarding exemption from the provisions at issue (article 21, Law No. 413/1991).

Therefore, the amendment to the regulation causes ruling requests to become optional regarding the exemption from CFC regulations, thus creating a substantial alignment with provisions of the regime on deductibility of blacklist costs.

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Income Determination of PE

To streamline requirements of nonresident corporations and to rationalize the relevant regulation to align it with OECD indications and guidelines, the draft legislative decree would revise the rules on the determination of income deriving from activities carried out in the state's territory by nonresident companies and entities through a PE.

In particular, in line with the option to adhere to the OECD's blueprint on the theme of income allocation to PEs of nonresident entities located in the state's territory, amendments to article 152 of the Italian Income Tax Code state that a PE's income must be determined on the basis of profits and losses that may be tracked back to it and under the provisions for entities subject to Italian income tax.

Moreover, to fully comply with business operations referring to PEs, the draft decree provides that nonresident entities draw up a special financial statement based on accounting principles for resident entities with the same characteristics.

The determination of a PE's income (just as is the case for endowment funds involving a PE) shall occur in compliance with OECD criteria, taking into account the various functions carried out, risks assumed, and assets used. The amendments confirm the application of the OECD principle that considers the PE a functionally separate entity to which any income to be allocated thereto, as well as the amount of the related endowment fund, is the figure resulting from the functional and factual analyses intended to identify functions, risks, and assets in consideration of the absolute centrality of the PE.

To provide taxpayers with greater certainty, and in line with the rationale on which the entire legislation is based, the tax authorities shall have to establish in a special provision the relevant methods to quantify the endowment fund on a standard basis that shall not therefore be determined on an accounting basis.

Italian companies shall be allowed to benefit from the exemption of profits and losses attributable to the sum total of their PEs abroad by simultaneously waiving any tax credits for taxes paid abroad.

As part of the concept that PEs are to be regarded as autonomous and independent entities, it is established that income components deriving from transactions entered into by and between a PE and its parent company must be determined using transfer pricing rules (article 110, paragraph 7 of the Italian Income Tax Code).

In accordance with the explanatory report to the draft legislative decree, the application of the ''functionally separate entity approach'' is also valid for determining the net production value for Italian regional tax on productive activities. ◆

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