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Italy's CFC Regime: Wholly Artificial Arrangements

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In Italy the subject of controlled foreign corporations is extremely topical. The Italian Revenue Office issued Circular 51/E of October 6, 2010 (the circular), which clarified the first significant amendments introduced by article 13 of Decree-Law 78 of July 1, 2009 (the decree), on CFCs.

An especially innovative change in the decree affects the scope of the CFC rules. The rules have been extended to controlled entities residing in countries or territories that are not blacklisted, whenever the entities may be qualified as ''wholly artificial arrangements.''

Articles 12 and 13 of the decree amended the CFC rules regarding the fight against tax havens and international tax arbitrages.[1] In particular, article 13 of the decree introduced a great number of amendments and supplements to article 167 of the Italian Income Tax Code (Testo Unico delle Imposte Dirette, or TUIR), including additional paragraphs 8-*bis* and 8-*ter*.

Those provisions were included as a response to the European Commission's request to member states to ''revise their anti-avoidance rules'' (see COM(2007) 785, dated December 10, 2007) with reference to entities availing themselves of wholly artificial arrangements in other states. They strictly refer to CFCs according to article 167 TUIR and do not apply to foreign associated subsidiaries under article 168 TUIR.

The primary purposes of the rules are to counter:

- tax deferral, deriving from the CFC's location in states or territories allowing greater tax benefits regarding national regulations; and
- tax avoidance.

The struggle against tax deferral is historically an intrinsic objective in the CFC rules, whereas the struggle against avoidance is the result of a more recent concept that is becoming increasingly widespread within the international community, as the main (if not the one and only) bottom-line justification for the CFC rules.[2]

This article sheds some light on the theme of the CFC rules, putting special focus on new paragraphs 8-*bis* and 8-*ter* of article 167 TUIR and on the clarifications in the circular.

Extended Scope of CFC Rules

New paragraph 8-*bis* of article 167 TUIR extends the application of the CFC rules to controlled entities residing in states or territories specified in a decree to be issued by the Ministry of Economy and Finance under article 168-*bis* TUIR (the so-called white list).

[1]By means of a document (Note 15/2009, which contained comments expressed within an interassociative Steering Committee regarding article 13 of the decree) jointly drawn up by the industrial associations of Abi, Ania, Assonime, and Confindustria. The note highlights that the abstraction operation foreseen by law, besides being exceedingly burdensome, is also rather complex from a practical standpoint. However, it does not take into account the considerable difficulties with timing aspects involved in advance tax rulings, which, under the circular, should be filed by June 1 of the year following the relevant year for which exclusion from the CFC rules has been requested.

[2]*See* Note 15/2009, *supra* note 1.

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The extension is valid only if the following two conditions are both met:

- the CFC enjoys the benefits of a particularly low tax regime[3]; and
- it primarily realizes passive income or profits derived from the supply of intercompany services.

In practical terms, the provision under examination extends the application of the CFC rules to all CFCs that may (even if only potentially) give rise to avoidance phenomena, regardless of their physical location.

'Wholly Artificial Arrangement' Concept

When the two conditions mentioned above apply/are met, new paragraph 8-*ter* allows the resident controlling entity to request exclusion from the CFC rules through the tax ruling procedure set forth under article 11 of Law 212 of July 27, 2000.

Article 167, paragraph 8-*ter* TUIR establishes, in effect, that:

> provisions under Paragraph 8-*bis* are not applicable if the resident entity is able to prove that its foreign establishment does not represent an artificial arrangement with the purpose of achieving undue tax advantages. For the purposes of the Paragraph hereof, the taxpayer must consult with the Revenue Office in accordance with procedures set forth under the foregoing Paragraph 5.

The circular interpreted that provision, along with the new rules introduced by article 13 of the decree, as indicating that the Revenue Office intended to provide some preliminary clarifications on the application of the renewed CFC rules, which became effective as of tax year 2010.[4]

The expression used by the legislature in paragraph 8-*ter* is reminiscent of the concept of wholly artificial arrangements expressed by the European Court of Justice in the well-known *Cadbury Schweppes* judgment (C-196/04, Sept. 12, 2006).[5] Nevertheless, in the foregoing matter, the judges acknowledged the compatibility of the CFC rules with the principle of freedom of establishment outlined in article 49 of the Treaty on the Functioning of the European Union (formerly article 43 of the EC Treaty) only with reference to resident controlled companies in a member state that represent ''wholly artificial arrangements intended to circumvent national law.''[6]

That position clearly emerges from the juridical norm of the Court's decision, which often is barely applied and which states that:

> Articles 43 EC and 48 EC must be interpreted as precluding the inclusion in the tax base of a resident company established in a Member State of profits made by a controlled foreign company in another Member State, where those profits are subject in that State to a lower level of taxation than that applicable in the first State, unless such inclusion relates only to wholly artificial arrangements intended to escape the national tax normally payable. Accordingly, such a tax measure must not be applied where it is proven, on the basis of objective factors — ascertainable by third parties — that notwithstanding the existence of tax motivations, the controlled company is actually established in the host Member State and carries on genuine economic activities there.

In other words, according to the ECJ, a corporate arrangement may not be deemed merely artificial if:

> on the basis of objective elements that may be verified by third parties, what emerges is that — although in the presence of tax-relevant motivations — the CFC is *effectively established in the host Member State* and there carries on genuine economic activities.[7] [Emphasis added.]

This is because:

> the activities corresponding to the profits of the CFC could just as well have been carried out by the company established in the territory of the Member State where the resident company is established, does not warrant to conclude that there is a wholly artificial arrangement.[8]

As to the phrase ''aimed at achieving undue tax advantages,'' which also emerges from the interpretation of paragraph 8-*ter*, the circular clarifies that it represents, within a European context, a mere specification of the concept of wholly artificial arrangement.

In particular, on the basis of the position adopted by the ECJ in *Cadbury Schweppes* (and clearly shared by the Italian Revenue Office), if the structure is effectively set up in the state of establishment and carries out actual business activities there, the subsistence of a

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[3]In the case in point, taxation must be less than half regarding the tax burden to which the enterprise would have been subjected had it been resident in Italy.

[4]*See* Revenue Office, press release, Feb. 5, 2010.

[5]For a more exhaustive analysis of the ECJ's judgment in *Cadbury Schweppes*, see P. Valente, *Fiscalità sovranazionale* (''Supranational Taxation''), Milan, 2008, p. 369 et seq.

[6]The expression used by the legislature (''wholly artificial arrangement'') is the translation of the corresponding French rule ''*montages artificiels dont le but est de contourner la législation fiscale française*,'' which, in turn, was borrowed from the ECJ's ''wholly artificial arrangements intended to circumvent National law'' (*Cadbury Schweppes*).

[7]*See Cadbury Schweppes*, Point 75.

[8]*See Cadbury Schweppes*, Point 69.

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tax advantage may be regarded as a subjective element that becomes quite secondary — in other words, it would not be deemed merely artificial in view of the objective elements identified.

As a consequence, in the absence of a wholly artificial arrangement, any tax advantage that may have been attained is thus entirely irrelevant for application purposes of paragraph 8-*bis*.[9]

Nonapplicability of CFC Rule

Advance Tax Ruling

The circular (in paragraph 5.2) specifies that proof that the foreign structure ''does not represent an artificial arrangement with the aim to achieve undue tax advantages'' must be provided during the tax ruling[10] (which is mandatory[11]) and submitted in accordance with procedures set out under article 167, paragraph 5 TUIR.

The procedure provides for the possibility of the nonapplicability of the CFC rules, should the taxpayer succeed in demonstrating that the foreign structure is actually endowed with an effective business substance.

Nevertheless, as confirmed by EU positions,[12] any artificiality of the foreign arrangement must be valued on a case-by-case[13] basis by the Revenue Office (during the ruling), in accordance with ''objective elements that may be verified by third parties.''

The Revenue Office's answer to the advance tax ruling (ATR) is not binding on the taxpayer, who in any case is free to choose whether to comply. It would be easy to prove (for example, during litigation) the subsistence of the exempting provision required *by virtue of law*.

The circular (in paragraph 5.2) also specifies that certain objective restrictions must be considered when making valuations regarding the nonapplicability of the CFC rules regarding CFCs located in countries that are not blacklisted.

In this case, reference is made to special indexes that would allow the taxpayer to support its evidence regarding the fact that the foreign structure ''does not represent an artificial arrangement with the purpose of achieving undue tax advantages.''

Whenever the taxpayer succeeds in providing the requested evidence by availing itself of those indexes, the Revenue Office is compelled to exclude the application of the rules in question.

A non-exhaustive list of those indexes, which represent the foreign structure's degree of artificiality, may be found in the June 8, 2010, EU Council resolution on the coordination of rules regarding CFCs and on thin capitalization, published in the EU Official Gazette C-156 of June 16, 2010.

The list is:

(a) lack of valid economic or business reasons (sound economic or business purposes) for the attribution of profits, which do not, therefore, correspond to effective economic conditions;

(b) the incorporation does not essentially correspond to a real company meant to carry out a genuine business activity;

(c) no proportional correlation exists between the activities apparently carried out by the CFC and the extent to which the said company actually exists for tax-relevant purposes in terms of premises, personnel, and equipment;

(d) the nonresident company is overcapitalized — it avails itself of a capital that is much higher than that needed to carry on a business activity; and

(e) the taxpayer has concluded transactions devoid of any economic substance, with little or no business purpose whatsoever, or which might be contrary to general business interests, had these not been concluded for tax evasion purposes.

Point (a) provides the indicator that essentially retraces the concept of valid economic reasons (sound business purposes) as the basis for the general anti-avoidance clause (that is, article 37-*bis* of Presidential Decree 600 of September 29, 1973).

Point (b) refers to the requirement of the factuality of the business being carried out.

Point (c) identifies the indicator that requires evidence of the extent to which the CFC is present on the foreign territory (that is, *in loco* availability of premises, personnel, and equipment[14]). That evidence may be provided in accordance with same procedures set forth under article 167, paragraph 5a TUIR, meaning that a

[9]As may be noted under the circular, the interpretation adopted in the *Cadbury Schweppes* decision has been essentially confirmed by subsequent ECJ case law (see, e.g., *Test Claimants in the Thin Cap Group Litigation*, C-524/04, Mar. 13, 2007) and the European Commission in its communication COM(2007) 785 of December 10, 2007, regarding ''the application of anti-abuse measures in the direct taxation area within the EU and towards third Countries.''

[10]Reference is made to the ''ordinary'' tax ruling governed by article 11 of Law 212/2000.

[11]In the sense that this is the only way for the nonapplicability of the CFC rules. In the absence of any tax ruling, proof of an exempting provision may only be submitted during litigation (and not during tax assessment). *See* Circular 32/E of June 14, 2010.

[12]*See* ECJ, *Leur-Bloem* (C-28/95), July 17, 1997, Point 41.

[13]So-called case-by-case analysis.

[14]*See Cadbury Schweppes* and COM(2007) 785 of December 10, 2007.

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taxpayer must provide documents that prove the foreign structure's existence and suitability for the carrying out of the stated business activity, that the activity is being carried out, and the CFC's managerial autonomy.

Point (d) refers to CFCs whose capital is significantly disproportionate regarding real entrepreneurial needs.

Finally, point (e) is similar to point (a), with the specification that in addition to the absence of any valid economic reason (sound business purpose) of the transactions, there might be reasons conflicting with general entrepreneurial interests such as, for example, the purpose of tax avoidance.

As far as banking, financial, and insurance activities are concerned, the circular provides that further elements[15] must be considered in view of the intangible nature of those activities.[16]

Validity of Opinion

The circular specifies that the opinion provided regarding the nonapplicability under article 167, paragraph 8-*bis* TUIR is not restricted to the tax period to which the nonapplication request pertains.

Once it is established that the foreign ''arrangement'' is not artificial, the evaluation may not be changed if the characteristics of the arrangement are not subject to change.[17]

Critical Aspects of ATR Procedure

Regarding the ATR procedure set out under article 167, paragraph 8-*ter* TUIR, the following issues arise:

- The computation of the actual tax burden requires an examination of the CFC's tax return, the availability of which depends on the filing terms of the relevant foreign country.
- The requirement of having an answer well before the filing deadline (June 1) creates objective practical difficulties.
- The reversal of the burden of proof, and consequent obligation to begin a tax ruling procedure aimed at the nonapplicability of the CFC rules, subjects the taxpayer to considerable administrative burdens. These burdens are connected to the necessity of monitoring conditions and, upon their occurrence, proving the non-subsistence of an artificial arrangement.

Thus, in that respect, incompatibility profiles with the principle of proportionality expressed by the ECJ and the European Commission may be identified.

The commission has asserted, on the basis of ECJ case law, that the need to prevent avoidance or abuse may justify a limitation of fundamental freedoms but *on the condition that national tax rules be proportional*. In particular, when a purely artificial arrangement is presumed, the taxpayer must provide evidence, without excessive administrative burdens, of the business reasons underlying the transaction.

In that situation, the Revenue Office's required evaluation during the ATR will be reduced to the bare minimum. Paradoxically, what might occur is that although the arrangement is not an artificial one, the Revenue Office may be obliged to respond unfavorably to the ruling procedure because it is required to strictly comply with the new provisions.

Concluding Remarks

With the introduction of these new amendments, the application scope of the new CFC rules might attract a large number of foreign companies that may not necessarily represent wholly artificial arrangements but that, on the contrary, are endowed with substantial factuality.

At first, this may seem to be inconsistent with the principle stated by the ECJ in its *Cadbury Schweppes* judgment,[18] which establishes that for CFC legislation to be aligned with EU law, ''taxation provided by the same must not be applied if, although in the presence of tax-relevant motivations, the incorporation of a CFC corresponds to an effective business.''

In the light of those considerations, the compatibility of the Italian CFC rules with EU law ought to be

[15]Those elements are:

- Description of functions actually carried out by the CFC, as well as assets used and risks assumed. The assets, in particular, are to be described in terms of profitability, risk level, and available funds.
- Description of economic-financial relations of the foreign company with other group companies, specifically volume and kind of transactions — receivable and payable — entered into with the same during the relevant period.
- Indication of the amount of ''typical'' income components regarding the activity carried out by the foreign company and comparison between such data and the data disclosed in the financial statements of the resident controlling company. For example, when a foreign company carries out a banking activity, the indication of the percentage incidence of the typical negative component (bad debts and losses on credits) on the typical asset (credits), as well as the comparison between such data and the result deriving from the analogous ratio (bad debts/value of credits disclosed in financial statements) recorded by the foreign controlling company, must be provided.
- Financial statements analysis of the foreign company highlighting profit level indicators of own capital and of total capital invested and comparison with those indicators of the resident controlling company.

[16]*See* COM(2007) 785 of December 10, 2007.

[17]In that case, a request for a new tax ruling must be submitted.

[18]*See* C-196/04, Point 65.

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verified, because of the significant extension of the regime's application scope, the consequent administrative burden on taxpayers, and the reduced exemptions available to taxpayers.

Moreover, with reference to Italian tax law, there are legitimate concerns about the new CFC rules' compatibility with the constitutional principle of taxpaying capacity. In that respect, an interposition by the Constitutional Court censuring articles 167 and 168 TUIR for violating article 53 of the Italian Constitution might seem reasonable.

However, the effects entailed — especially in terms of greater administrative burdens engendered by the recently amended provisions — for taxpayers included in the scope of application may be easily guessed. Special reference is made here to the analytical verification required by the rules in every tax year of the effective taxation level in the sense of comparing foreign taxation with the Italian taxation system, converting the income result realized ''*in loco*'' into the result that would derive from the application of internal rules — in other words, some kind of ''fiscalization'' of the profit and loss account of the company established in the foreign state.

All of the foregoing might negatively impact the competitiveness of Italian enterprises. ◆

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