

Court Rules on Characterization of Subsidiary

by Marco Rossi

Reprinted from *Tax Notes Int'l*, August 6, 2007, p. 510

Court Rules on Characterization of Subsidiary

by Marco Rossi

Italy's Supreme Court on June 11 issued judgment 13579-07 on the application of Italy's estate tax on a nonresident individual who inherited assets connected with Italy. In its decision, the Court addressed the characterization of an Italian subsidiary as a permanent establishment of its foreign parent for purposes of determining whether the parent company's stock, inherited by a Swiss-resident individual, is subject to Italy's estate tax. Although the case concerns the application of Italy's estate tax, the Court's ruling has significant income tax implications, as it is largely based on the concept of PE that applies in the area of direct taxes.

Issues and Facts of the Case

Nonresident persons are subject to Italian estate tax on their assets in Italy — namely, stock or other capital interests in companies and partnerships organized in Italy or having their registered seat, place of management, or principal place of business in Italy (the same criteria established in article 73 of the Italian Tax Code for determining residency for income tax purposes).

Under the facts of the case, an individual resident in Switzerland inherited various assets, including tangible assets located in Italy, the stock of a Panamanian company, and the stock of a Swiss company that owned 100 percent of the stock of an Italian operating company.

The Italian tax administration stated that the Swiss company's Italian subsidiary constituted a PE in Italy of the Swiss parent and that the Swiss parent's principal place of business was in Italy, where it operated through its wholly owned Italian subsidiary/PE. As a consequence, the Swiss company had to be considered a domestic (resident) entity, tax authorities said, and its stock was an Italian asset subject to estate tax in Italy. The taxpayer subsequently challenged the estate tax assessment in court.

The tax court partially upheld the challenge, although it is not clear from the description of the facts of the case which aspects it supported. However, the tax court ultimately confirmed the application of the estate tax on the stock of the Swiss company. The taxpayer appealed that finding to the appellate court, which rejected the appeal. The taxpayer then appealed to the Supreme Court.

Supreme Court's Reasoning

According to the Court, the relevant issue is whether the Swiss company's Italian subsidiary can be characterized as its PE in Italy.

If that question is answered in the affirmative, then because the Swiss company's sole activity is holding the stock of the Italian subsidiary, it would result that the Swiss company's sole business is located in Italy, where it operates through its wholly owned Italian subsidiary/PE. Consequently, the Swiss company would be an Italian-resident company under the principal place of business test, and its stock would be an asset located in Italy subject to the application of Italy's estate tax.

If answered in the negative, the Swiss company would be a foreign (nonresident) company based on the location of its registered seat, place of management, and place of business (Switzerland, where it holds the stock of its Italian subsidiary), and the Italian estate tax on the stock of the Swiss company would not be due.

The Court addressed the issue by referring to article 5, paragraph 6 of the Italy-Switzerland income tax treaty, which says that the sole fact that a company in one contracting state is controlled by a company in another contracting state is not sufficient, in itself, to characterize the former as a PE of the latter.

The Court observed that this conclusion is in line with a previous decision, *Ministry of Finance (Tax Office) v. Philip Morris (GmbH)*, *Corte Suprema di*

Cassazione no. 7682/02 of May 25, 2002, in which it found the existence of a PE on the basis of the parent-subsidiary relationship accompanied by other elements, such as the subsidiary's active participation in contractual negotiations on behalf of the parent and supervision of the parent's business in Italy. (For prior coverage of the Italian Supreme Court's decision in *Philip Morris*, see *Tax Notes Int'l*, Apr. 1, 2002, p. 1404.)

Because, in the case under analysis, the tax administration referred to no other facts to justify treating the Italian subsidiary as a PE of the Swiss parent and to enable it to assert its taxing power on the stock of the Swiss parent, the Court held that the estate tax was not due.

However, the Court also noted that for companies organized in tax haven jurisdictions that do not have tax treaties with Italy that include a provision similar to article 5, paragraph 6, the conclusion may be different.

Comments

The decision is important, as it shows that the tax administration and the courts may be willing to use or consider an argument based on the recharacterization of an Italian subsidiary as the PE of its

parent, and the consequent recharacterization of the foreign parent as an Italian company based on the principal place of business test (in the case of pure holding companies) to assert Italian tax jurisdiction in cross-border situations that may be perceived as abusive. That could have major implications in the area of income taxes.

Also, the Supreme Court seems to suggest that a stricter standard applies to offshore companies organized in low-tax jurisdictions that do not have a tax treaty with Italy, in which case the mere control relationship may be used to recharacterize the subsidiary as a PE on the basis of its real economic nature, disregarding the legal structure. In that particular situation, according to the Court, the mere control relationship may be sufficient evidence, as the standard of proof on the tax administration is less stringent.

Consequently, taxpayers should continue paying attention to this area of law, as the courts are shifting toward the use of substance-over-form analyses and arguments to justify a wider application of Italy's taxing powers. ♦

♦ *Marco Rossi, Marco Q. Rossi & Associati,
Genoa and New York*