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tax notes international

Volume 44, Number 13 ■ December 25, 2006

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Reprinted from *Tax Notes Int'l*, December 25, 2006, p. 1064

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The year 2006 has been an active year for international tax developments in Italy.

Italian international tax rules have continued to develop as a result of new legislation, case law decisions, and administrative pronouncements on several important international tax issues.

At the EU level, several European Court of Justice decisions have directly affected the interpretation and application of Italy's domestic tax rules.

Finally, Italy has ratified two new tax treaties and the 1988 Convention on Mutual Administrative Assistance in Tax Matters.

Legislative Developments

2006 Budget

New measures enacted at the end of 2005 in connection with the approval of the Budget Law for 2006 took effect.

The new provisions primarily affect the rules that exempt stock gains and dividend from tax (participation exemption rules), amortization of goodwill, and the deduction of financial lease payments.

The exempt portion of gain has been reduced to 91 percent (producing a 2.97 percent effective tax rate) for gains realized in 2006 and to 84 percent (producing a 5.28 percent effective tax rate) for gains realized in 2007.

The minimum holding period for the exemption of stock gains has been extended from 12 to 18 months, but remains at 12 months for the deduction of stock losses. Therefore, sale of stock held more than 12 but less than 18 months generates taxable gains and nondeductible losses.

Lawmakers have enacted an antiabuse rule providing that losses from the sale of portfolio stock (not eligible for participation exemption) are nondeductible to the extent of any exempt dividends distributed regarding that stock in the 36-month period preceding the sale. The antiabuse rule does not apply when dividends on the stock are fully taxable or gain was not eligible for a participation exemption while held by the seller. (For related coverage of antiabuse rule guidance, see *Tax Notes Int'l*, July 3, 2006, p. 7.)

Dividends on portfolio stock held by individual shareholders are fully taxable if distributed by a company organized in a low-tax country included in the blacklist.

Goodwill is amortizable on a straight-line basis over 18 years.

Rents paid under a real property financial lease agreement are deductible on a pro rata basis over a 15-year period.

Other Tax Measures

With Law Decree 223 of July 4, a series of sweeping tax measures were adopted to fix the increasing budget deficit and restore balance in Italy's public finance. The new measures affect the ability to deduct tax losses and change other important tax rules. (For prior coverage, see *Tax Notes Int'l*, Aug. 28, 2006, p. 699.)

Tax losses incurred during the first three tax years can be carried over indefinitely (according to the general rule) only if they arise from a new business activity. Therefore, for mergers, spinoffs, or the contribution of a business to an existing or newly formed company, the acquiring company cannot benefit from the unlimited tax loss carryover rule for losses that arise from the same business conducted by the transferor or acquired company. The rule applies retroactively to losses that would not have been deductible if the rule had been in effect when the losses were incurred; those losses, however, are subject to an eight-year carryover limitation.

In case of an election for fiscal transparency, an entity's owners' distributive share of the entity's taxable income cannot be used to offset the owners' preexisting tax losses. For mergers with retroactive effects, the rules on limitation of the use of a merged company's net operating losses also apply for determining the amount of deductible losses relating to the period between the beginning of the tax year and the completion of the merger.

The minimum thresholds for determining whether a company is a nonoperating company and determining a nonoperating company's minimum imputed taxable income have been tightened.

A company is deemed to be nonoperating if its gross receipts fall below 2 percent of the value of stock, below 6 percent of the value of its real estate, or below 15 percent of the value of other assets (intangibles) carried as fixed assets on its balance sheet (measured by book value).

A nonoperating company's minimum imputed taxable income is set at 1.5 percent of the value of stock, 4.75 percent of the value of real estate, and 12 percent of the value of other assets (intangibles) carried as fixed assets on the company's balance sheet (measured by book value).

Under new anti-inversion rules, a foreign company is deemed to be resident in Italy for tax purposes (and subject to tax in Italy on its worldwide income) if controlled by Italian residents or if its director or the majority of the members of the board of directors are Italian residents.

Dividends originating from companies organized in blacklisted jurisdictions are fully taxable. Look-through (tracing) rules apply to back-to-back dividends. The new rule is intended to contrast the use of an intermediate entity organized in a good jurisdiction to benefit from the 95 percent dividend received exemption.

Trademarks can be amortized on a straight-line basis over 18 years (the same as goodwill).

Patents can be amortized over two years (reduced from three years).

Transfers and leases of real property are subject to registration tax (at the total rate of 10 percent, including cadastral and mortgage tax) and are exempt from the VAT. Input VAT is no longer deductible.

Employees are subject to tax on stock option gains upon exercise of the option. Gain carryover at the time of stock sale has been repealed.

Personal exemptions and deductions for calculation of individuals' personal income tax have been unavailable to nonresident individuals subject to tax in Italy on their Italian-source income, but the 2007 Budget Law repeals that restriction.

2007 Budget

Gift and estate taxes have been reinstated — at rates of 4 percent, 6 percent, or 8 percent of the value of the gift or decedent's estate, depending on the position of the beneficiaries in the family chain, with an exemption of €1 million for the spouse and children.

Antiavoidance provisions of Tax Code section 110(10) that limit the deduction of costs incurred with entities organized in blacklisted (tax haven) jurisdictions have been extended also to fees and expenses charged by lawyers and other professionals domiciled in those jurisdictions.

Personal exemptions and deductions for nonresident individuals taxable in Italy on their Italian-source income, which had been repealed with the July 2006 tax measures, have been reinstated.

Carryover of gain on employees' stock option exercise is again available, provided that three conditions are met:

- the option is exercised more than three years after the granting date;
- the stock is publicly traded; and
- the stock acquired is held for at least five years after exercise of the option.

The eight-year carryover limitation for pre-July 2006 losses within the first three years after the granting date has been repealed. As a result, the new provisions limiting the deductibility of losses in the first three years apply only prospectively.

Case Law

The Supreme Court in judgment no. 17206/06 (July 28, 2006) affirmed its decision in *Ministry of Finance (Tax Office) v. Philip Morris (GmbH)*, Corte Suprema di Cassazione, no. 7682/05 (May 25, 2002), and recharacterized a domestic subsidiary company that engaged in contract negotiations on behalf of its foreign parent and performed managerial functions relating to its foreign parent's business activities as the foreign parent's permanent establishment in Italy. The Court stated that the new commentaries to the OECD model income tax treaty adopted after its decision in *Philip Morris* are to be regarded as recommendations and do not bind Italian courts, considering also that Italy expressed reservation at the time they were adopted. (For related coverage, see *Tax Notes Int'l*, Nov. 13, 2006, p. 507.)

Also, the Regional Tax Commission (tax court of appeals) of Venice in judgment no. 17/10/06 (Apr. 20, 2006) recharacterized an Italian company that was economically and legally dependent on its foreign affiliate as the foreign affiliate's permanent establishment in Italy.

The Supreme Court in order no. 21371 (Oct. 4, 2006) asked the European Court of Justice to clarify the scope of the antiabuse doctrine elaborated in its VAT decision in *Halifax plc et al. v. Commissioners of*

Customs and Excise (C-255/02). The Italian Supreme Court applied the antiabuse doctrine at the domestic tax level and also in the area of income tax. (For related coverage, see *Tax Notes Int'l*, Dec 4, 2006, p. 735.)

Finally, the Supreme Court in ruling no. 22023 (Oct. 13, 2006) ruled that the tax administration must provide proof of tax avoidance before it proceeds with transfer pricing adjustments. (For related coverage, see *Tax Notes Int'l*, Nov. 27, 2006, p. 667.)

Administrative Developments

In Ruling 170/E (Dec. 12, 2005), the tax agency stated that the provisions of Tax Code article 167 (controlled foreign companies rules) also apply to entities organized in EU member states. The Italian blacklist for the controlled foreign companies rules includes low-tax countries that have recently joined the European Union, such as Malta and Cyprus. (For related coverage, see *Tax Notes Int'l*, Jan. 23, 2006, p. 269.)

In Ruling 9/E (Jan. 17, 2006), the tax agency ruled on the tax consequences of a case involving a Spanish company that moved its fiscal residency into Italy, stating that if the company maintains its foreign charter it is subject to tax in Italy for the entire taxable period in which the transfer of its tax residency took place. (For related coverage, see *Tax Notes Int'l*, Oct. 23, 2006, p. 303.)

In Ruling 44/E (Mar. 30, 2006), the tax agency imputed a minimum capital to a foreign company's Italian branch, based on the branch's functions and risks, and denied the deduction of interest accrued regarding debt allocated to the branch and carried on the branch's books, to the extent of the minimum capital imputed to the branch. (For related coverage, see *Tax Notes Int'l*, May 22, 2006, p. 675.)

In Circular 81 (June 16, 2006), the tax administration acknowledged the European Court of Justice's decision in *Ministero dell'Economia e delle Finanze, Agenzia delle Entrate v. FCE Bank plc* (C-210/04), in which the ECJ held that intracompany transfers between a company's head office and a branch, or branches of the same company, are not relevant for VAT purposes. (For related coverage, see *Tax Notes Int'l*, July 10, 2006, p. 109.)

In Ruling 86/E (July 12, 2006), the tax agency ruled on the meaning of the beneficial ownership requirement for tax treaty benefits with respect to a back-to-back license arrangement. The agency denied a U.S. sublicensing company treaty benefits that would reduce withholding tax on royalties under the Italy-U.S. tax treaty, arguing that the sublicensing company did not have legal title to, and economic possession of, the royalty income that it collected from the licensees and passed on to the ultimate patent owners.

In Ruling 124/E (Nov. 7, 2006), the tax agency took the position that the transfer of functions from a permanent establishment in Italy to its foreign head office constitutes a deemed liquidation of the permanent establishment, which triggers taxable gain on all the permanent establishment's appreciated assets, including intangibles such as long-term contracts, customer lists, know-how, and goodwill. (For related coverage, see *Tax Notes Int'l*, Nov. 20, 2006, p. 585.)

EU Developments

In 2006 the European Court of Justice rendered three important judgments directly affecting Italy's tax laws.

In *FCE Bank plc* (C-210/04) (Mar. 23, 2006), the ECJ held that no VAT is due on services provided to an Italian branch by its foreign head office, because the branch and the head office are components of the same single entity for VAT purposes. (For the ECJ judgment in *Ministero dell'Economia e delle Finanze, Agenzia delle Entrate v. FCE Bank plc* (C-210/04), see *2006 WTD 57-6* or *Doc 2006-5658*.) Italy's tax administration acknowledged the decision in Circular 81 (see above).

In *Stradasfalti s.r.l. v. Agenzia delle Entrate* (C-128/05) (Sept. 14, 2006), the ECJ held that the restrictions on the deduction of input VAT on vehicles set forth in Italy's VAT implementing legislation violate the EC Treaty (for failing to provide prior notice to the Advisory Committee on VAT and failing to set forth "cyclical economic reasons" that would justify the restrictions). (For the ECJ judgment in *Stradasfalti s.r.l.*, see *2006 WTD 179-7* or *Doc 2006-19286*; for related coverage, see *Tax Notes Int'l*, Nov. 6, 2006, p. 429.)

In *Banca Popolare di Cremona* (C-475/03) (Oct. 3, 2006), the ECJ held that article 33 of the EU VAT Sixth Directive, as amended by Council Directive 91/680/CEE, does not preclude Italy's IRAP, or regional tax on production activities. (For the ECJ judgment in *Banca Popolare di Cremona* (C-475/03), see *2006 WTD 192-9* or *Doc 2006-20583*.)

The European Commission warned Italy (and five other EU member states) that domestic tax rules would violate the freedom of movement of capital of article 56 of the EC Treaty in subjecting outbound intercompany dividends to a higher tax burden than domestic intercompany dividends. Domestic dividends are not subject to withholding tax and are tax-exempt to the corporate shareholder, while outbound dividends are subject to withholding tax (at a

27 percent rate, reduced usually to 5 percent under tax treaties and eliminated by the parent-subsidiary directive).

The European Commission also referred Italy to the European Court of Justice for failing to implement Directive 2003/123/CE, which amends the parent-subsidiary directive and should have been implemented by January 1, 2005.

Treaty Developments

Italy on January 31, 2006, ratified the Council of Europe/OECD Convention on Mutual Administrative Assistance in Tax Matters signed in Strasbourg on January 25, 1988. The convention entered into force in Italy on May 1, 2006, and contains extensive and important provisions on assistance for cross-border assessment and enforcement of taxes among contracting states.

With Law no. 288 (Dec. 30, 2005), Italy ratified the Congo-Italy tax treaty, which was signed on October 15, 2003. The treaty provides for an 8 percent withholding tax on direct dividends and a 15 percent withholding tax on portfolio dividends, zero withholding tax on interest, and a 10 percent withholding tax on royalties.

Italy has also ratified with Law no. 48 (Feb. 6, 2006) the tax treaty it signed with Ghana. The treaty was signed in Accra on February 19, 2004. ◆

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