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Italy Clarifies Withholding Tax Treatment of EU Dividends

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Italy Clarifies Withholding Tax Treatment of EU Dividends

Italy's tax administration on May 21 issued Circular 26/E, which provides guidance on the application of the reduced withholding tax on EU dividends (paid to companies that are resident in EU or European Economic Area member states that are included in a special white list). EU dividends distributed out of earnings and profits accumulated in tax years that began on or after January 1, 2008, are subject to a reduced withholding tax rate of 1.375 percent.

Circular 26/E clarifies that the provision that allocates dividends in reverse chronological order, beginning first with profits accumulated in earlier tax years, does not apply. Therefore, the distributing company is free to allocate the distribution to profits accumulated in tax years that began on or after January 1, 2008, and apply the reduced withholding tax. The circular also clarifies that the recipient of the dividend qualifies for the reduced withholding tax if it is organized as a company subject to a corporate tax under the laws of its country of residence, even if it does not actually pay any tax as a result of an exemption that is compatible with EU law or that is granted in connection with the particular nature of the entity's income (for example, passive income earned by investment companies).

Therefore, investment funds that are organized as companies in their country of residence but are not subject to tax on their investment income (such as some Luxembourg or Irish investment funds) could qualify for the reduced EU dividend withholding tax rate.

Withholding Taxes on Dividends

Italian-source dividends paid to nonresident persons (other than those attributable to a permanent establishment of the nonresident person in Italy) are subject to a 27 percent withholding tax. The tax applies both to portfolio and intercompany dividends paid to companies or individual shareholders.

The tax rate is reduced to 12.5 percent for dividends paid on a special class of nonvoting stock (saving shares). If the recipient of the dividend is a resident of a treaty country, the withholding tax typically is reduced to 15 percent for portfolio dividends and to 5 percent for intercompany dividends, under the tax treaty.

The recipient of the dividend can apply for a refund of the tax paid in its country of residence on the dividend received, for an amount not exceeding four-ninths of the Italian withholding tax (or 12 percent of the top 27 percent withholding tax). Proof of payment of the foreign tax can be provided by means of a certificate issued by the foreign tax authority.

Dividends paid by an Italian subsidiary to an EU parent company that qualifies for the benefits of the EU parent-subsidiary directive are free from withholding tax. For the directive's withholding exemption to apply, the recipient company must be resident in an EU member state, must be subject to corporate income tax in its country of residence, and must directly own at least 10 percent of the stock of the distributing company for 12 consecutive months at the time of the payment of the dividend.

Dividends paid to an Italian company are not subject to withholding tax. The recipient company is taxed on 5 percent of the amount of the dividend at the ordinary corporate tax rate of 27.5 percent. The result is an effective tax rate on dividends equal to 1.375 percent.

Reduced EU Dividend Withholding Tax

The European Court of Justice, in its judgments in *Denkavit* (C-170/05) of December 14, 2006, and *Amurta* (C-379/05) of November 8, 2007, and the European Free Trade Association Court in its November 23, 2004, judgment in *Fokus Bank ASA* (E-1/04), ruled that EU member states' national laws that subject outbound dividends to a less favorable tax treatment than that applicable to domestic dividends violate the freedom of establishment clause of the EC Treaty. (For the ECJ judgments in *Denkavit* and *Amurta*, see *Doc 2006-24958* or *2006 WTD 241-13*, and *Doc 2007-24955* or *2007 WTD 218-13*, respectively. For prior coverage of the EFTA Court's ruling in *Fokus Bank*, see *Doc 2004-22633* or *2004 WTD 229-3*.)

This was exactly the case in Italy, which subjected outbound dividends to a 27 percent withholding tax (reduced to not less than 5 percent under tax treaties), compared with the 1.375 percent effective tax applicable to domestic dividends.

To eliminate that discrimination and bring Italian law into compliance with the EC Treaty, Italy in its budget law for 2008 enacted new provisions (now included in article 27-*ter* of Presidential Decree 600 of 1973) under which dividends paid to a company resident in an EU or EEA member state that is on the white list are subject to withholding tax at the reduced rate of 1.375 percent. This equalizes the treatment of EU outbound dividends and domestic dividends.

The reduced rate applies to dividends on shares of stock or payments under financial instruments or other contractual arrangements that are composed entirely of profits of the issuer or contracting party and are characterized as dividends for tax purposes.

Requirements for the Reduced Rate

The reduced withholding tax rate applies to profits distributed to companies and other entities that are subject to a corporate income tax. Individual shareholders, partnerships, and other fiscally transparent entities do not qualify.

At the moment, the only EEA member state that is on the white list is Norway. EEA members Iceland and Liechtenstein are not included; therefore companies in those countries are not eligible for the reduced rate.

In short, to qualify for the reduced rate, two requirements must be satisfied: the residency requirement and the subject-to-tax requirement. The residency requirement is tested under the tax laws of the resident country of the recipient.

Subject-to-Tax Requirement

Circular 26/E clarifies that the subject-to-tax requirement is satisfied if an entity is a separate entity for tax purposes and is generally liable for a corporate (entity-level) tax under the internal laws of the resident country, even if the company or entity does not in fact pay any corporate tax as a result of an exemption that is compatible with EU law.

Circular 26/E makes reference to paragraph 2.2 of Circular 47 of November 2, 2005, which provides a similar clarification on the same requirement that applies for the purpose of exempting from withholding tax the interest and royalties paid by an EU affiliate to an EU parent company, in accordance with the EU interest and royalties directive (2003/49/EC).

Circular 26/E further clarifies that the subject-to-tax test is met even if the recipient entity does not pay any corporate income tax in its country of residence because of an exemption granted in connection with the nature of its income or in connection with the source of the income (such as in the case of companies that are exempt from tax on earnings derived through foreign branches).

Procedural Aspects

For the reduced withholding tax to apply, the payee must provide to the payer a certificate issued by the tax administration of the recipient's EU member state of residence certifying that the recipient is resident of that state and is subject to a corporate income tax under the laws of its country of residence.

The payee can obtain the certificate of payment of the dividends from the payer to claim a tax credit for the Italian withholding tax in its country of residence.

Entry Into Force

The reduced withholding rate applies to dividends paid out of profits accumulated in tax years beginning after the tax year that is in effect as of December 31, 2007. Therefore, for calendar-year taxpayers, the reduced withholding tax applies to dividends distributed out of profits accumulated in 2008 and thereafter.

The payer shall notify the payee about the tax years to which the distributed profits are allocated and to what extent the distribution is made out of profits of 2008 or following years (and subject to a reduced rate), or out of profits of 2007 and prior years (and subject to the ordinary tax rates).

The payer shall also keep separate profits accounts for the allocation of the dividends in order to determine the appropriate tax rate. ◆

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