Practitioners' Corner

Italy's International Tax Ruling Procedure

by Marco Rossi

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Multinational enterprises doing business in Italy (and Italian enterprises doing business abroad) can use the international tax ruling procedure (the ruling procedure) to reach an advance agreement with Italy's tax administration regarding the taxation of income derived from cross-border transactions. The ruling procedure can be considered analogous to the various advance pricing agreement programs that are common practice in many jurisdictions around the world, but it is unique in that it is not confined to transfer pricing issues but extends to all international tax issues arising from cross-border business transactions. The ruling procedure is reasonably fast and wide in scope and should be considered by foreign multinationals wishing to minimize unpredictable results and the cost of audits or potentially painful court litigation. Because the ruling procedure has received scant attention internationally and little (if any) application in practice, it may be useful to describe its essential features, particularly from the perspective of a foreign taxpayer investing in Italy.

Eligibility

The ruling procedure was implemented by article 8 of Law Decree 269 of September 30, 2003, and was converted into Law 326 of November 24, 2003 (Law 326). The tax administration issued specific guidance for the application of the international tax ruling procedure in a notice dated July 23, 2004 (the notice).

Taxpayers eligible for the ruling are "resident enterprises engaged in international transactions." The general definition is clarified in the notice. The term "enterprise" includes a sole proprietorship, partnership, company, or any other unincorporated business entity. The term "resident (enterprise)" means a permanent establishment located in Italy or a partnership, company, or other business entity resident in Italy for tax purposes. The term "engaged in international transactions" is defined as follows:

- a resident enterprise (defined as above) subject to Italy's transfer pricing rules of Tax Code section 110, paragraph 7; this occurs in the case of
  - — PEs in Italy owned by a nonresident, with respect to transfer of goods and services between the PE and its home office or other related foreign entities;[1]
  - — resident entities, with respect to transactions entered into with foreign related parties (that is, foreign entities controlling the resident entity, controlled by the resident

[1]Italy adopts a separate entity approach and tests the transfer of goods and services between a PE in Italy and its home office abroad under the arm's-length standard. Controlled transactions between a PE and other entities of the same group are also subject to transfer pricing rules.

entity, or controlled by the same foreign entity that controls the resident entity);

- all or part of the assets, equity, or fund of a resident enterprise that are owned by a nonresident (this includes a nonresident taxpayer's PE in Italy or foreign-owned Italian entities), or a resident enterprise that owns all or part of the assets, equity, or fund of a foreign person (this includes a resident taxpayer's PE in a foreign country or Italian-owned foreign entities);[2]
- a resident enterprise that pays to or receives from a foreign person (related or unrelated) dividends, interest, or royalties; or
- a foreign person that is engaged in a trade or business in Italy through a PE.

A foreign taxpayer can apply directly for the ruling procedure if it is engaged in business activities in Italy through a PE. In all other cases, it can apply for the ruling procedure indirectly through the Italian entity that it owns or with which it does business and that is involved in the transaction that is the subject matter of the ruling.

Scope of the Ruling

When defining the matters that can be covered by the ruling procedure, the statute expressly refers to transfer pricing, dividends, interest, and royalties (both inbound and outbound). However, it is clear that the ruling procedure also extends to issues concerning PEs (existence of and attribution of profits to a nonresident's PE in Italy or a resident's PE in a foreign country). In all cases the ruling extends to the treatment of a specific transaction under domestic law (and EU tax law if relevant) and any applicable treaty. Therefore, the ruling procedure covers all possible international tax issues that may arise from a foreign taxpayer's investment or business operation in Italy or from a transaction with an Italian counterpart (related, or in case of interest and royalties, also unrelated) and that may generate Italian-source income subject to tax in Italy. Those issues are examined with reference to both Italy's domestic tax laws and any applicable tax treaty between Italy and the foreign country involved. The ruling procedure can be used:

- to address PE issues such as whether a foreign taxpayer's presence in Italy amounts to a PE; the amount of income attributable to that PE; the consequence of restructuring, liquidating, or transferring a PE; and the tax treatment of transfer of goods or services between the PE and its head office or other entities of the group;[3]
- to determine the arm's-length price of controlled transactions entered into between an Italian subsidiary and its foreign parent or another foreign related entity (such as a low-taxed manufacturing or distributing subsidiary of the group);
- to determine the withholding tax applicable to dividends paid by an Italian entity to its foreign owner (including eligibility for tax treaty benefits or for the exemption from withholding tax under the EU parent-subsidiary directive);
- to determine the tax treatment of interest paid by an Italian entity to its foreign parent, a related foreign financing entity, or an unrelated foreign entity (including possible reduction or elimination of withholding tax under any applicable tax treaties or the EU interest and royalties directive, disallowance of deduction under Italian thin capitalization rules, debt-equity recharacterization rules or other domestic rules on limitation of interest deduction, and similar issues); and
- to determine the tax treatment of royalties paid by an Italian entity to its foreign parent, a foreign related licensing entity, or a third party (including possible reduction or elimination of withholding tax under any applicable tax treaties or the EU interest and royalties directive).[4]

The ruling procedure does not apply to controlled foreign corporation issues because income inclusion under CFC rules does not involve a payment. The ruling procedure can be used to clarify tax issues arising from a single transaction or a series of transactions that are part of the same investment or

[2]There is no minimum ownership requirement for the purpose of this part of the international transaction test.

[3]Italy follows the separate entity approach (like the approach taken in article 7.2 of the OECD model income tax treaty), and transfer pricing standards apply to transfer of goods or services between an Italian PE and its foreign head office.

[4]The ruling may also cover payments made by an Italian entity to a foreign entity. Therefore, foreign multinationals owning Italian companies that own foreign companies can use the ruling across the board. However, because the ruling is a unilateral agreement with Italy's tax administration concerning only the tax treatment of a specific item of income or transaction under Italian law, the application of the ruling procedure to inbound payments subject to withholding tax in the foreign country is of no use in determining the application of the withholding tax in the foreign country of source. The ruling procedure can still be effectively used to resolve transfer pricing issues regarding income received by the Italian entity (thereby avoiding the risk that Italy would assess a higher price and thereby increase the income in the hands of the Italian recipient).

business operation. The transaction submitted with the ruling application may have already been entered into or may have been in place. Indeed, the agreement reached at the end of the ruling procedure applies retroactively from the beginning of the tax year in which the agreement is reached.

The ruling procedure covers all possible international tax issues that may arise from a foreign taxpayer's investment or business operation in Italy or from a transaction with an Italian counterpart.

From the perspective of nonresident taxpayers engaged in investments or business transactions in Italy, it is important to point out that the ruling procedure can be used to address in advance any issues concerning the proper application of Italy's tax treaties by Italy as the source country. This, of course, would include problems concerning the eligibility for treaty benefits in the first place. Treaty benefits (low withholding rates on portfolio income, exemptions, nondiscrimination protections, and PE provisions) may be denied for several reasons. First, regarding portfolio or investment income, they can be denied on the basis that the taxpayer claiming the benefits is not a resident of the other contracting state under the general definition of residency for treaty purposes contained in article 4 of the OECD model treaty, or that it does not satisfy the specific requirements of a treaty's limitation on benefits article (if any). Second, they can be denied under domestic anticonduit provisions or judicial doctrines.[5] Third, they can be denied under other treaty rules — for instance, on the basis that the immediate recipient of the income is not the "beneficial owner" of the income for treaty purposes.[6] Finally, specific problems may arise in the context of payments made to or by fiscally transparent or hybrid entities.[7] For business income, major problems may arise regarding the application of the treaty's PE threshold to protect a nonresident taxpayer from taxation of its business income earned in the host country.[8]

All these issues can be part of the international tax ruling procedure and can be addressed and agreed on in advance by the taxpayer and the tax administration.

Ruling Procedure

The ruling procedure begins with a taxpayer's application,[9] which must provide all information about the taxpayer and the transaction(s) submitted with it, so that the tax administration can determine, as a preliminary matter, if the request falls within the scope of the ruling. If the application concerns transfer pricing matters, the taxpayer must also submit information about the transfer pricing methods and calculations used to determine the prices applied to the transaction.

Within 30 days of receiving the taxpayer's application, the tax administration must notify the taxpayer if it thinks that the application is not feasible (because the taxpayer is not eligible for the ruling or

[5]From the U.S. perspective, reference can be made to IRC section 7701(l) and the regulations issued thereunder and to the Tax Court decision in *Aiken Indus. Inc. v. Comm'r,* 56 T.C. 925 (1971). Italy does not have specific anticonduit statutory or regulatory provisions. However, it does have anticonduit general statutory rules (Tax Code article 2 and article 37(3) of Presidential Decree 600 of September 29, 1973), and the Supreme Court in two recent decisions drafted and applied a general antiabuse or anticonduit doctrine to deny tax benefits to what was perceived as an abusive transaction.

[6]The U.K. Court of Appeal's recent judgment in *Indofood International Finance Ltd. v. JPMorgan Chase Bank, N.A., London Branch* ([2006] EWCA Civ 158) is an example of how the beneficial ownership clause can be used to deny the application of treaty benefits.

[7]These problems are rarely addressed in tax treaties. The OECD model income tax treaty does not contain any specific provisions on the application of treaty benefits to hybrid entities. However, the OECD has issued a report on this matter (published in 1999 and titled "The Application of the OECD Model Tax Convention to Partnerships"), and the commentary to the treaty contains several paragraphs that reflect the conclusions reached in that report. The 1996 U.S. model income tax treaty contains specific provisions on the application of treaties to fiscally transparent entities at article 4(1)(d), and detailed rules have been enacted at the U.S. domestic level with regulations issued under IRC section 894(c).

[8]These problems are far from settled. The Italian Supreme Court decision in *Ministry of Finance v. Philip Morris* (*GmbH*), Suprema Corte di Cassazione, No. 7682/02 (May 25, 2002), is an example of the detriment that taxpayers may suffer as a result of improper planning and unpredictable outcomes at the court level. That decision was largely perceived as incorrect by the international tax community (and forced the OECD to refine the concepts applied by the Italian Supreme Court to avoid similar results), compared with the general international tax principles regarding the taxation of a nonresident's PE in the host country. It is a good example of how any downside that may be seen in the international tax ruling process should be assessed in light of even worse results at the administrative and judicial levels.

[9]The application must be directed to the International Tax Ruling Office of the Agency of Revenues, based in Milan for taxpayers located in northern and some central regions, and based in Rome for taxpayers located in southern and other central regions.

because the matters submitted with the application fall outside the scope of the ruling) or if it needs additional documentation to determine the admissibility of the application. If the application is admissible, the applicant and the tax administration meet to discuss the matters concerning the ruling. During the negotiations, the tax administration can require additional documentation or negotiate with the taxpayer how and when it can directly collect additional information and peruse additional documentation at the taxpayer's place of business. Law 326 and the notice do not clarify the scope of the tax administration's powers in that regard, and much room and discretion is left to the negotiations between the parties. The procedure must be concluded within 180 days of the date the application was filed. When the tax administration seeks information from foreign tax authorities under cooperation or information exchange agreements, the deadline can be extended until the time at which the information is obtained.

The Agreement

The agreement reached by the tax administration and the taxpayer must set forth the transfer pricing methods, calculations and results, or the tax treatment of the specific matters submitted with the ruling application in all other non-transfer-pricing cases (under Italy's domestic law as modified by any applicable tax treaties and also taking into account the impact of EU tax law provisions), as agreed on by the taxpayer and the tax administration. The agreement is binding on both the taxpayer and the tax administration for a period of three years (including the year in which the agreement is reached if the transaction was already in place at the time of the application). The tax administrations of the other countries involved are also notified of the agreement.[10]

Anticipated Termination of the Agreement

After reaching an agreement with a taxpayer, the tax administration has the power to check that the facts and circumstances (and the law) on the basis of which the agreement had been reached have not changed. For this purpose, the taxpayer must (i) provide the tax administration with the relevant information or documentation, periodically or on specific request, and (ii) allow the tax administration's officials to collect or review relevant information and documentation at the taxpayer's place of business.[11] If the tax administration believes that the facts have changed, it notifies the taxpayer, which then has 30 days to submit its comments. If no comments are provided or those provided are considered insufficient, and no new agreement is reached between the parties that reflects the change in circumstances, the tax administration can terminate the agreement.[12] The anticipated termination takes effect from the date on which the relevant facts changed or, if that date cannot be determined with reasonable accuracy, from the date the agreement was entered into.

Renewal of the Agreement

The agreement can be renewed not later than 90 days before its expiration. The tax administration must notify the taxpayer of its acceptance or rejection of the request of renewal not later than 15 days before the expiration of the agreement.[13]

Conclusion

The advantages of Italy's international tax ruling procedure are the reasonable speed of the process (which may be limited to 180 days), the wide scope of the ruling (which can embrace all international tax issues arising from nonresidents' investments and business operations in Italy, including issues arising under tax treaties and EU tax law as well as outbound issues concerning Italian companies owned by foreign investors), and the possibility to achieve certainty on those issues over a reasonable period of time by means of an advance binding agreement with the tax authority having a duration of at least three years and renewable for the same period of time before its expiration.

The main disadvantage is the lack of details in the law regarding the tax administration's powers to

[10]The only purpose of this notification is to put the authorities of the other countries on notice, but that does not mean that the other countries' tax administrations are involved in or in any way party to the agreement. The agreement reached as a result of Italy's international ruling procedure remains a unilateral agreement between the taxpayer and Italy's tax administration.

[11]Neither Law 326 nor the notice clarifies the kind of information or documentation that the tax administration may request and that the taxpayer must provide. It would seem reasonable to say that it must be information and documentation directly related to the matters covered by the agreement and strictly necessary to determine if there has been any relevant change of facts and circumstances that might lead to an anticipated termination.

[12]This decision is not automatically binding on the taxpayer, who can maintain that the agreement is still in force and dispute the termination of the agreement or any assessment of taxes made by the tax administration.

[13]The notice does not clarify what remedies the taxpayer may have in case of unreasonable refusal to renew the agreement when none of the relevant circumstances have changed. Therefore, the conclusion is that the tax administration may refrain from renewing the agreement at the expiration of the three-year period at its absolute discretion.

inspect taxpayers' books and records and request additional information and documentation, within the ruling process and before and after an agreement has been reached, to determine if any change in the facts and circumstances or the applicable law has occurred that may trigger an early termination of the agreement.

The unilateral nature of the agreement is not necessarily a major disadvantage because (outside of transfer pricing cases) when the problem at issue is the tax treatment of a specific transaction by Italy as the country of source, settling that issue with the country of source may be all the taxpayer really needs to achieve.

To avoid unanticipated outcomes and harsher consequences as a result of unilateral audits carried out by the tax administration, foreign investors should carefully consider applying for an international tax ruling to determine the tax treatment of certain transactions they are involved in that cannot always be satisfactorily sorted out at the administrative level or successfully defended in court. ◆