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Italy's tax administration on April 26 issued Ruling 80/E, clarifying taxation of Italian partners of a foreign partnership.

A foreign entity law firm organized as a limited liability partnership under U.K. law intends to carry out professional services in Italy through a fixed base located there. Some of the partners of the U.K. LLP are Italian residents. Italian residents own shares of interests in the LLP that are nonqualified shares under Italian law (shares that represent less than 2 percent of voting rights or 20 percent of capital if publicly traded, or 5 percent of voting rights or 25 percent of capital if not publicly traded).

Under U.K. law, the LLP is treated as a fiscally transparent entity, so its partners are taxed on their distributive share of the profits of the LLP when realized, regardless of distribution.

U.K.-resident partners are taxed on their distributive share of the LLP's worldwide income, while Italian-resident partners are taxed on their distributive share of the LLP's income from U.K. sources.

The partnership agreement provides that the LLP will distribute each year to the partners their distributive share of the profits of the LLP net of any tax owed by the partners, in the U.K. or elsewhere, which the LLP will pay on behalf of the partners.

The taxpayer requested clarification on the following:

- whether the LLP would be subject to corporate income tax in Italy on the profits attributable to the services performed through its Italian fixed base;
- whether the profits distributed by the LLP to its Italian partners, net of any taxes withheld and paid by the LLP in the U.K. or any other country, under the partnership agreement, would be characterized and taxed as dividends to the Italian partners for Italian tax purposes; and
- if the profits are treated as income from professional services (ordinary income), whether a foreign tax credit would be granted to the Italian partners for any foreign taxes paid on those profits.

In response, the tax administration provided some clarifications on the tax treatment in Italy of a foreign entity classified as a partnership (fiscally transparent entity) under foreign law. Some issues remained unaddressed.

First, the administration observed that the LLP is treated as fiscally transparent under U.K. law — it is not subject to tax in the U.K. on its income, which passes through to the partners, and it is taxed directly upon them. Consequently, the LLP is not entitled to the benefits of the Italy-U.K. treaty because it does not qualify as a resident of the U.K. under the treaty definition of resident set forth under article 4.

Because, based on the facts of the ruling, the LLP would have a fixed base or permanent establishment in Italy and it would be taxable in Italy on profits attributable to its Italian fixed base or permanent establishment, under articles 5 and 7 of the treaty, that observation would not seem to be immediately relevant for purposes of the ruling.

However, it confirms that Italy is willing to follow the OECD approach, adopted in the OECD partnership report, regarding the application of treaty benefits to partnerships or other fiscally transparent entities.

The administration failed to clarify that, to the extent that the country of residence of a partner treats the partnership as fiscally transparent and taxes the partner on her distributive share of the partnership's income, the benefits of any treaty in existence between Italy and that partner's country of residence would apply (regardless of the tax classification of the partnership under Italian law).

Regarding taxation of the LLP in Italy, the tax administration confirmed that the LLP is treated as a separate taxable entity —that is, like a corporation for Italian tax purposes, regardless of its tax classification and treatment under foreign law — and it is subject to corporate income tax on its income attributable to the services performed in Italy through its Italian fixed base.

Italian taxable income would be computed according to the rules on computation of income from performance of independent services.

Regarding the taxation of Italian partners in Italy on the profits distributed by the LLP, the tax administration confirmed that profit distributions would be treated as portfolio dividends and would be subject to the flat-rate gross basis tax of 12.5 percent (charged in lieu of the ordinary personal income tax) with no foreign tax credit.

If distributions are received through a resident bank, the bank will withhold the tax upon receipt of the distribution; if distributions are received directly, the partner will report the profits received in her income tax return, and they will be subject to the 12.5 percent tax.

There would be no election to include the profits received in the partner's ordinary income and claim a foreign tax credit for any foreign taxes paid on those profits.

Finally, the tax administration addressed the most important issue, concerning the taxable base on which the flat rate 12.5 percent tax should apply.

According to the taxpayer, the tax should apply on the amount of the profits distributed, net of any amount withheld by the partnership as taxes paid on behalf of the partners under the partnership's operating agreement.

Instead, according to the tax administration, because the tax is not technically a withholding tax, any amount withheld by the partnerships under an internal agreement among the partners would still be part of the profits distributed to the partners and taxable as dividends upon the Italian partners.

Consequently, the Italian partners would be unable to get even the limited benefit of a deduction for any taxes paid by the partnership on their distributive share of the partnerships' income.

As a result of the conflicting classification of the entity under Italian and foreign laws and Italian taxation of foreign-source portfolio dividends through a flat-rate gross basis tax with no foreign tax credit, the taxpayer is exposed to double taxation.

One issue that was not part of the ruling concerns the possible taxation in Italy of the profits of the LLP attributable to the activities performed through its Italian fixed base and distributed to the partnership's foreign partners.

According to Tax Code article 23, paragraph 1, letter b, income from capital paid by a foreign entity's Italian permanent establishment is Italian-source income. Income is treated as paid by a permanent establishment when the payment is connected with, or attributable to, profits arising from activities carried out by the permanent establishment.

The operative provision of article 27 of Presidential Decree n. 600 of September 39, 1973, provides for no withholding tax on dividends paid by (that is, out of profits attributable to) an Italian permanent establishment of a foreign entity. The withholding tax applies only on dividends distributed by resident companies.

It may be still argued that Italian tax is due under the general rules whereby nonresidents are subject to tax in Italy on their Italian-source income (Tax Code articles 3 and 24).

However, as a practical matter, the withholding tax is the only viable way to collect the tax on Italian-source passive income, and in the absence of a provision imposing the withholding tax, the income is deemed not subject to tax at all. ◆

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