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New CFC legislation: the Italian tax authorities publish their interpretation

The Italian tax authorities have finally published the long-awaited guidelines on the new Italian CFC legislation (Circular No. 51/E of 6 October 2010). The new CFC legislation is described in a previous briefing, available here .

This briefing is focused on the tax authorities' interpretation of the key changes in the CFC legislation:

- the narrowing of the safe harbour provided by the CFC legislation for a foreign subsidiary that carries on a genuine industrial or commercial activity (the "**Active Business Test**"); the Active Business Test applies to foreign subsidiaries established in black listed states or territories (or not resident in a white listed state or territory, once the new white list is approved and subject to certain grandfathering provisions);

- the broadening of the scope of the CFC legislation, applying it also to foreign subsidiaries established in white listed jurisdictions (including EU Member States) when (i) the subsidiary's proceeds derive mainly from the management of, or investment in securities, equity interests, receivables or other financial instruments, from the exploitation of IP or from the supply of intra-group services ("**Passive Income**"), (ii) the subsidiary is subject to an effective tax rate which is lower than 50% of the equivalent Italian rate, and (iii) the relevant Italian parent does not demonstrate that the subsidiary does not constitute a "wholly artificial arrangement".

The tightening of the Active Business Test

The safe harbour has been amended so that the CFC legislation will not apply if the foreign company carries on an actual business activity in the market in which it is established. The safe harbour now requires the main input or output of the activity of the foreign subsidiary to be actually on the market in which the subsidiary is established. Before these amendments, it was sufficient for the foreign subsidiary to demonstrate that it a genuine business organisation in the country of establishment, regardless of the input or output markets of the foreign subsidiary.

Under the Circular, the foreign subsidiary may pass the new Active Business Test – and will not be treated as a CFC - if its Italian parent shows that the subsidiary actually participates to the economy of its host State or territory, within the meaning set forth in the Cadbury Schweppes decision by the European Court of Justice (decision of 12 September 2006, C- 196/04, paragraph 53). Interestingly, the Circular makes reference to the ECJ decision to guide the interpretation of a provision (the Active Business Test) that would apply only to non-EU subsidiaries. Such participation is normally measured in terms of the foreign subsidiary's actual interaction with the local market in terms of purchases or sales (respectively, the local input market and local output market).

Key Issues

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Special guidance is provided to identify the reference "market" for banking and insurance activities. In the case of insurance activities, the market will be identified as the state or territory where the risks are located. For banking activities, reference will be made to where the foreign subsidiary sources and uses its funding. Hence, a foreign banking or insurance subsidiary established in a blacklisted jurisdiction will pass the test only if it serves predominantly local clients or it draws funds predominantly on the local market.

While clarifying the application of the Active Business Test, the Circular extends the test's scope to activities generating Passive Income, despite the legislation expressly providing that the Active Business Test is not available when more than 50% of the proceeds of the foreign subsidiary is Passive Income. Notwithstanding, the Circular takes the position that the relevant Italian parent may still be in position to prove that the establishment of the foreign subsidiary earning Passive Income was motivated by reasons other than tax reasons and the foreign subsidiary actually carries on an active business. In other words, a foreign subsidiary earning mainly Passive Income would in principle be deemed to have been established to obtain an undue tax advantage, but the Italian parent may be to demonstrate that this is not the case by satisfying a heavier burden of proof that the foreign subsidiary was established for genuine business purposes and actually carries on an active business.

Extension of the CFC legislation to white listed jurisdictions

The most significant change adopted is the broadened application of the Italian CFC legislation to a foreign subsidiary of an Italian company in any jurisdiction (including EU Member States) if:

- subject to a tax that is less than half of the Italian tax that would be applicable to its income had it been resident of Italy for tax purposes (the "**Effective Tax Rate Test**"); and

- more than half of its proceeds is Passive Income.

If the foreign subsidiary meets the above tests, the Italian parent may still avoid the application of the CFC legislation if it demonstrates, through a ruling procedure that the establishment of the foreign subsidiary does not constitute a “wholly artificial arrangement”.

The Circular sets out several important clarifications, especially in relation to the Effective Tax Rate Test and the notion of wholly artificial arrangement, which should guide both taxpayers in filing their ruling applications and the tax authorities' response.

Firstly, for the purposes of the Effective Tax Rate Test, the foreign level of taxation should be measured in terms of the effective rate applied in any given year, taking into account also any losses to be carried forward that are generated after the entry into force of the new CFC legislation, or after the Italian taxpayer has acquired control over the foreign subsidiary, if later. The Italian "virtual" tax is to be measured having regard only to the corporate income tax (IRES) currently levied at 27.5% (i.e. IRAP, levied at 3.9% would not be taken into account).

Great uncertainty had been generated by the application of the Effective Tax Rate Test on foreign holding companies established in white listed jurisdictions and benefiting from the participation exemption. In fact, the Italian participation exemption provides that eligible dividends and capital gains would be exempt from corporate income tax for 95% of their amount, thus resulting in an effective tax rate of 1.375%. Such effective tax rate is higher than twice the effective tax rate normally resulting from the application of most participation exemption regimes in other jurisdictions, which normally provide for a full exemption. Hence, the question arose as to whether a foreign holding company being fully exempt on eligible dividends and capital gains would pass the Effective Tax Rate Test. The Circular takes the position that taxation of 5% (that originally constituted a form of recapture of costs attributable to the relevant participation) should be deemed equivalent to the full exemption. However, this would not exempt the Italian taxpayer from having to file the ruling application. In other words, foreign participation exemption regimes are equivalent to the Italian participation exemption regime only for the purposes of determining whether there was an abuse in establishing the foreign holding company. Such determination, however, is left to the tax authorities under a formal ruling application procedure.

The Circular also confirms that the Effective Tax Rate Test would have to be performed on an annual basis, using the foreign subsidiary's actual income and tax rate for that year. However, once the foreign subsidiary has passed the tests to be considered a CFC and the Italian parent has obtained a favorable ruling confirming that the foreign company does not constitute a "wholly artificial arrangement", the ruling will remain valid while the facts and circumstances concerning the foreign company remain unchanged, thus relieving the Italian taxpayer from having to file annual ruling applications.

The ruling process and the notion of "wholly artificial arrangement" in the Circular

The Circular confirms that a foreign subsidiary earning Passive Income is to be deemed a CFC only if it constitutes a "wholly artificial arrangement", within the meaning set forth by the Cadbury Schweppes decision. Somewhat in contrast with wording of this decision, however, the Circular specifies that "wholly artificial arrangement" has the same meaning as "undue tax advantage". The Circular makes clear that the fact that the foreign company earns Passive Income is in it and by itself a sign that an abuse is presumed to exist, and that proof to the contrary would have to be provided by the Italian parent in the context of a ruling procedure, started by the application by the Italian parent. The tax authorities' reply upon the completion of the ruling procedure is not binding upon the Italian parent, who may choose to disregard it. The Italian parent would retain the right to challenge any ensuing assessment brought forth by the tax authorities and to demonstrate that the foreign subsidiary does not constitute a wholly artificial arrangement before the tax court.

Replies to the ruling applications would have to be based on objective elements that, according to the Circular, should be consistent with the Council Resolution of 8 June 2010 on coordination of the Controlled Foreign Corporation (CFC) and thin capitalisation rules within the European Union (2010/C 156/01. According to the Circular, indicia that a foreign subsidiary has not been established for genuine business purposes (thus constituting an artificial arrangement) include the following circumstances:

- insufficiently valid economic or commercial reasons for the profit attribution, which therefore does not reflect economic reality;
- incorporation does not essentially correspond with an actual establishment intended to carry on genuine economic activities;
- there is no proportionate correlation between the activities apparently carried on by the CFC and the extent to which it physically exists in terms of premises, staff and equipment;
- the foreign company is overcapitalised, it has significantly more capital than it needs to carry on its activity;
- the taxpayer has entered into arrangements which are devoid of economic reality, serve little or no business purpose or which might be contrary to general business interests, if not entered into for the purpose of avoiding tax.

Following this line of reasoning, the Circular goes on to state that evidence that a certain arrangement is not "wholly artificial" could be, for example, the fact that the foreign company has a genuine organisational structure, i.e. premises, employees and assets. At the same time, the Circular admits that certain activities, such as banking and finance, do not necessarily require a significant "material" structure, as confirmed by the Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee on the application of anti-abuse measures in the area of direct taxation within the EU and in relation to third countries, COM(2007) 785 final. While this Communication does not delve on this particular point, the Circular lists examples of the type of information that the taxpayer should submit as evidence in the context of the ruling process to assist the tax authority's determination as to whether a the foreign structure should be deemed artificial. The Circular provides that the Italian parent should describe:

- the functional profile of the foreign subsidiary (functions/risks/assets, with particular reference, for the assets, to their risk/return/liquidity profile);
- the business relationships with other group companies; and
- the "typical" items present in the P&L account of the foreign company, compared to that of the Italian parent (significant discrepancies might be an index of anomaly, so that proof to the contrary should be included);
- the comparison of the profitability ratios of the foreign subsidiary to those of the Italian parent.

Miscellaneous clarifications

Amongst the several other definitions contained in the Circular, the following appear worth mentioning:

- the ruling application will have to be filed in due time to allow the tax authorities to reply prior to the deadline for the filing of the tax return of the Italian parent; assuming that an Italian parent's financial year ends on 31 December, for a ruling in relation to 2010, the application would have to be filed by 1 June 2011 (as the deadline for filing the 2010 tax return is 30 September 2011);
- under CFC legislation, Italian parents may avoid the application of the provision to subsidiaries either (i) if the subsidiary passes the Active Business Test or (ii) by showing that the shareholding in the foreign subsidiary does not achieve a goal of localising income in blacklisted countries or territories. The Circular clarifies that, for this purpose, the foreign subsidiary's actual level of income taxation has to be calculated considering the income taxes levied across the entire chain of ownership in any given year; so that, for example, a foreign subsidiary established in a blacklisted jurisdiction whose profits are regularly distributed every year (and thus are subject to full taxation in Italy, or in another jurisdiction in where an intermediate holding company is established) would pass the test notwithstanding the fact that the profits were originally subject to little or no tax. Again though, the Italian parent would be required to prove this through a ruling process.

Preliminary comments

By and large, the Circular seems to suggest that the new CFC legislation will be an issue only for arrangements that are predominantly aimed at obtaining a tax advantage through the establishment of foreign subsidiaries without a genuine business purpose and/or an actual local business establishment that are subject to a favourable tax regime. Whether this is true will depend on how the tax authorities' approach and response to the ruling applications.

In contrast, the new CFC legislation has become much more severe. Access to the safe harbor based on the Active Business Test becomes more difficult for foreign subsidiaries established in blacklisted jurisdictions. Recently, the tax authorities' have been using a more rigid and narrow approach, resulting in a majority of the ruling requests being turned down. Hence, Italy-based groups have long given up tax planning using the subsidiaries established in low tax (and blacklisted) jurisdictions. The tightening of the CFC legislation on subsidiaries based in blacklisted jurisdictions, therefore, is not likely to bring about any meaningful consequences for most Italy-based groups.

The practical application of the new legislation to banking, financial and insurance groups having subsidiaries established in blacklisted jurisdictions (such as the off-shore financial centres) remains to be seen. Most of those groups had originally obtained a favourable ruling on the Active Business Test on the basis of the genuine business substance of their operations (in line with the pre-existing practice of the tax authorities to focus on the location of the customer base rather than on the existence of a genuine business substance). Now that the tax authorities' view has been reflected in the legislation, these groups will have to go through another ruling procedure. The outcome of these new procedures is less likely to be favourable for those foreign subsidiaries serving the international community at large than for those that serve their local or regional market. At the same time, the more benign interpretation provided under the Circular, which opens up the Active Business Test also to foreign subsidiaries earning mainly Passive Income that have been established for genuine business reasons, might leave some room for genuine banking and financial activities. Only the actual outcomes of the new ruling procedures will tell us if it is going to be so.

In relation to the broader scope of CFC legislation, which now applies also to non-blacklisted (i.e., whitelisted) jurisdictions, the Circular sets out a rather gloomy prospect for Italy-based groups that have foreign subsidiaries in jurisdictions that to date had not been affected by CFC legislation (such as subsidiary holding companies based in Luxembourg or group finance companies based in Ireland, to name a couple). In fact, the interpretation set out in the Circular on the one hand broadens the scope of the Effective Tax Rate Test to a wider range of cases, thus increasing the likelihood of the need to apply for a ruling procedure; on the other hand, it appears to set the benchmark for a "wholly artificial arrangement" exclusively on the basis of certain criteria such as the existence of employees, premises etc., also for those activities (such as the holding of equity interests) that would normally meet a few or none of those criteria.

Moreover, the wider scope of the ruling procedure could impose a significant burden on Italian parents that might be captured under the Effective Tax Rate Test only as a consequence of the mismatch of the rules for the computation of taxable profits in Italy and in the foreign jurisdiction, thus being obliged to go through the ruling procedure to avoid the application of the CFC legislation.

Again, only the outcomes of the ruling processes will tell us whether the application of the CFC legislation to white listed (including EU) jurisdictions will result in a serious blow to Italian groups organised internationally. In the case of subsidiaries established in EU Member States, the outcomes will have to be tested against EU law principles, such as the freedom of establishment (Article 49 of the Treaty on the Functioning of the European Union). While it is true that ruling replies are not be binding for the taxpayers, and that the final determination as to whether the establishment in a EU Member State is s a "wholly artificial arrangement" will be left to the courts, the Italian tax authorities could adopt an overly-restrictive approach, which - if consistent - might become a *de facto* restriction to the freedom of establishment.