CORPORATE TAX - ITALY

Tax Authority clarifies new CFC rules

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On August 4 2016 the Tax Authority issued Circular Letter 35/E, which clarifies Italy's controlled foreign companies (CFC) regime in light of recent changes under Budget Laws 190/2014 and 208/2015 and Decree-Law 147/2015.

New CFC criteria

The black-list criteria provided for CFC purposes have been significantly revised. The circular letter clarifies that as of fiscal year 2016, a foreign jurisdiction is deemed to be tax privileged if:

- corporate taxation is less than 50% of the nominal statutory taxation in Italy (foreign applicable income taxes shall be considered, while for Italian tax purposes the nominal tax rate is established by corporate income tax (IRES) and the regional tax on productive activities (IRAP)); or
- a special regime applies to resident entities. The Tax Authority defines a 'special regime' as a tax regime that:
  - applies to all taxpayers that satisfy the requirements provided under the local tax rules; and
  - provides for a reduction of the applicable tax rate or exemptions or other erosions of the taxable basis which result in a material reduction of tax due.

EU and European Economic Area (EEA) member states, apart from CFC white-listed jurisdiction regimes, are explicitly excluded from the CFC rules.(1) Italy's CFC rules provide that an Italian resident controlling, either directly or indirectly, an entity resident in a tax privileged jurisdiction (ie, a CFC country), must consolidate in Italy the taxable income arising from the CFC in proportion to the participation held. Taxable income from CFCs is calculated under the same rules applicable to an Italian resident, except for the deferred taxation of capital gains. CFC provisions are no longer applicable to 'related' entities (ie, shareholdings higher than 20% that do not grant legal control of the foreign entity).

Dividends distributed by CFC

If a CFC is deemed to exist, material clarifications have been provided with regard to the taxation of dividends paid by such CFC, which are – in principle – fully taxable in the hands of the Italian receiving company.

Thus, Article 167 of the Corporate Tax Act provides that where adequate evidence can be provided to demonstrate the existence of the 'first safe-harbour rule' (which implies that a foreign subsidiary "carries out an actual industrial or commercial activity as its principal activity in the State or territory where it is located"), even if the dividends are 100% taxable for IRES purposes, a foreign tax credit can be claimed. The circular letter clarifies that such credit is considered to be an indirect tax credit, as it is granted for taxes paid by the CFC and not directly by the Italian shareholder.

Conversely, the taxation of dividends received at the rate of 1.20%(2) is recognised if adequate evidence is provided to demonstrate the existence of the 'second safe-harbour rule', through which

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the Italian resident company must prove that from the beginning of the acquisition or incorporation of the controlling interest, "its investments do not have the effect of locating income in States or territories" with a privileged tax regime. It has been clarified that, in such cases, the criteria considered to define a 'privileged tax regime' for the possession period is the one used for the regime in force in the fiscal year in which the dividend is paid by the foreign entity.

The circular letter also confirmed that the second safe-harbour rule is relevant when a foreign subsidiary:

- benefits from a privileged tax regime, but produces over 75% of its income in countries or territories with a non-privileged tax regime, thus rendering it subject to ordinary taxation and unable to benefit from any special regimes;
- benefits from a privileged tax regime, but carries out its main activity or has its place of management in a jurisdiction that is tax privileged, and the income is fully taxed therein, without benefiting from a special regime; or
- is resident in a state or territory that is not tax privileged, without benefiting from special regimes, but carries out its activity in a jurisdiction that is tax privileged, through a permanent establishment, and the income of the permanent establishment is fully taxed in the parent company state.

Further, the second safe-harbour rule can be satisfied if the overall tax burden is equal to at least 50% of the taxes which would have been due had the foreign subsidiary been tax resident in Italy.

Finally, the circular letter also provides criteria regarding the application of CFC rules as amended. In order to verify whether foreign income is derived from a tax privileged country, the fiscal year in which the income has been collected (ie, in which the dividends are paid) will be taken into account by the taxpayer. In particular, on the basis of the detailed instructions provided by the Tax Authority, where dividend income has been collected in a fiscal year, but has been accrued by a foreign entity during multiple fiscal years, the resident company must apply the updated criteria (ie, the CFC tax rate is equal to at least 50% of the Italian nominal tax rate) to the previous years during which profits were accrued in order to determine whether the foreign jurisdiction could present a privileged tax regime. In this respect, profits accrued by a foreign entity that, due to the amended criteria in fiscal year 2016, is no longer a CFC but was a CFC during preceding years – because the country was included on the black list – could be distributed and treated by the parent company as dividend income received by a non-CFC entity. Conversely, dividends paid by an entity subject to a privileged tax regime (due to the amended criteria in force from fiscal year 2016), but accrued in fiscal years during which the same entity was not deemed to be a CFC (on the basis of the rules in force at the time) are considered as having been received by a CFC entity.

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Endnotes

(1) According to the CFC white-list rule, CFC rules are also extended to controlled companies that are not resident in a CFC Country – as defined above – or that are resident in EU or EEA member states if the following conditions are met:

- the effective tax rate in the foreign jurisdiction is lower than 50% of the tax that would have been charged if the company had been resident in Italy; and
- more than 50% of its revenues is derived from passive incomes (ie, interest, royalties, dividend and capital gains deriving from financial instruments) or intra-group services.

(2) That is, the new reduced IRES rate of 24% over 5% of the dividend.