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Italian tax authorities provide additional clarity over CFC regime

ANDREA SPINZI,
RAFFAELE GIGLIO

Studio Legale e Tributario Biscozzi Nobili Piazza | Corporate Tax - Italy

Introduction

Pursuant to article 167 of the Italian Tax Code (ITC), the controlled foreign company (CFC) regime applies to the following persons if certain objective requirements are met:

- Italian-resident persons (eg, individuals, companies and entities); and
- non-resident persons that have a permanent Italian establishment which controls foreign entities.

Foreign entities are considered to be "controlled" if at least one of the following conditions is met:

- They are directly or indirectly controlled, including through a trust company, by an Italian-resident person or by a non-resident person that has a permanent Italian establishment, according to the definition of "control" pursuant to article 2359 of the Italian Civil Law (ie, a company that either has the majority of or sufficient votes to exercise a dominant influence in the ordinary shareholders' meeting of another company or that exercises a dominant influence on another company by virtue of a special agreement).
- More than 50% of their share in profit is held, directly or indirectly, through one or more controlled companies or through a trust

company, by an Italian resident person or by a non-resident person that has a permanent Italian establishment.

Foreign permanent establishments of controlled non-Italian resident persons and foreign permanent establishments of Italian resident persons that apply the branch exemption regime are also controlled foreign entities.

Controlled foreign entities are subject to the CFC regime only if:

- they are subject to an effective tax rate (EFR) lower than 50% of the effective tax rate that would apply if they were resident in Italy (known as the "EFR test"); and
- more than one-third of their income consists of passive income (known as the "passive income test") – namely:
    - interest or any other income generated by financial assets;
    - royalties or any other income generated from intellectual property;
    - dividends and income from the disposal of shares;
    - income from financial leasing, insurance, banking and other financial activities;
    - income from transactions involving the purchase and sale of goods with little or no added economic value, carried out with parties that directly or indirectly control the controlled non-resident entity, are controlled by it, or are controlled by the same party that controls the non-resident entity;
    - income from services, with little or no economic value added, performed for the benefit of entities that directly or indirectly control the non-resident controlled entity, are controlled by it or are controlled by the same entity that controls the non-resident entity.

Under the CFC regime, the income of controlled foreign entities is subject to tax in Italy through a transparency mechanism, with the consequence to tax at the level of the Italian parent company, in proportion to the respective share of profits, all the income accrued by the controlled entity, regardless of the actual receipt of the same in the form of dividends.

In any case, the CFC regime does not apply if the Italian resident person (or non-resident person that has a permanent Italian establishment) demonstrates that the control foreign entity performs an effective business activity "by using personnel, facilities and office". A specific ruling can be submitted to the Italian tax authorities in this regard.

On 28 July 2022, the Italian tax authorities issued Circular No. 29/E, which provided clarifications regarding:

- the exit from the CFC regime; and
- the transfer of controlled foreign entities to Italy.

Exit from CFC regime

Paragraph 7.3 of Circular No. 18/E of 27 December 2021 and paragraph 7.3 of Circular No. 23/E of 26 May 2011 set out that exiting from the CFC regime was possible only through the demonstration of the exempting circumstance pursuant to article 167(5) of the ITC, which requires the participated company to perform an economic activity through the use of personnel, equipment, assets and premises. In the most recent circular, the Italian tax authorities have clarified that the taxpayer can also interrupt the CFC regime if it passes the ETR test and/or the passive income test.

According to the Italian tax authorities, this position is justified by the new approach of EU Directive 2016/1164, given that the eventual exit from and re-entry into the CFC regime is adequately governed. In fact, it shall be considered that a corporate income tax return includes an effective and reliable "monitoring" regime of CFC values, which allows the taxpayer to voluntarily (with an irrevocable option to be communicated to the Italian tax authorities) keep track of the trend of income and losses (virtually), as well as of the tax-recognised values of the CFC assets.

There is always the possibility to continue to apply the transparency taxation regime on a voluntary basis until the conditions for the demonstration of the exempting circumstance are met.

Transfer of controlled foreign entities to Italy

With regard to the so-called "entry tax" (article 166 bis of the ITC), paragraph 8.1 of Circular No. 18/E clarified that, where a foreign company transferring its tax residence in Italy has been qualified as a CFC during the period of residence abroad (with the consequent application of the transparency taxation regime), it cannot benefit from the step-up of tax values of the assets and liabilities at the time of entry, in application of the entry tax rules. Therefore, the tax values are equal to those used for the purposes of the CFC regime as of 31 December of the last year of transparency taxation (if the fiscal year coincides with the calendar year).

Now, considering that the CFC regime can be more easily interrupted, the Italian tax authorities have clarified in the most recent circular that the step-up of tax values is not foreseen only if the income of the foreign company is taxed for transparency on the Italian shareholder in application of the CFC regime in the tax period prior to the one immediately preceding its transfer to Italy. Therefore, the step-up of tax values is applicable if, in the aforementioned tax period prior to the transfer, the conditions of the CFC regime are not met or the exempting circumstance pursuant to article 167(5) of the ITC (the carrying out of an actual economic activity) is demonstrated.

The Italian tax authorities have also specified that, if the transfer of CFC to Italy does not occur in continuity of the CFC regime, the possible recognition of higher tax values is not related to whether or not the company maintains its fiscal residence also in the country of origin.

For further information on this topic please contact Andrea Spinzi or Raffaele Giglio at Studio Legale Tributario Biscozzi Nobili Piazza by telephone (+39 02 763 6931) or email (andrea.spinzi@sbnp.it or raffaele.giglio@sbnp.it). The Studio Legale Tributario Biscozzi Nobili Piazza website can be accessed at www.sbnp.it.