

Outbound Merger Not Tax-Free, Tax Authority Says

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Italy's tax administration on January 27 issued an advance ruling in which it concluded that the merger of an Italian company into a Spanish parent would not qualify for tax-free treatment under the EU merger directive.

According to ruling 21/E, eligibility depends on whether the activities performed in Italy by the Spanish company after the merger constitute a permanent establishment in Italy. The tax administration held that the Spanish company's activities are not included in the definition of permanent establishment; therefore the requirement for tax-free treatment is not satisfied.

Background

In the case at issue, a Spanish company that distributes and sells clothing and accessories wants to acquire the stock of an Italian company that would perform the following services:

- receipt of goods from Italian manufacturers and suppliers;
- storage and warehousing;
- quality and conformity control;
- packaging, shipping, and delivery of goods to the parent or customers; and
- collection and provision of information and other auxiliary services.

Immediately after the acquisition, to avoid administrative costs, the Italian company would be merged into the Spanish company and would continue to operate as the Spanish company's permanent establishment in Italy.

According to the taxpayer, the transaction should qualify as a tax-free merger under the provisions of the EU merger directive as implemented in Italy.

The taxpayer also maintained that the Spanish company, through its Italian PE, should be able to purchase the stock of other Italian companies and include

them in a domestic tax consolidated group in Italy, offsetting profits and losses among the members of the group.

The Ruling

The Italian tax administration disagreed, ruling that the merger would be a taxable transaction and that the Spanish company could not consolidate other Italian subsidiaries under Italian tax consolidation rules.

According to the tax administration, after the merger there would be no PE of the foreign parent company in Italy because the activities performed in Italy do not fall under the definition of a permanent establishment as provided in Italy's Tax Code.

Consequently, the tax treatment granted by the EU merger directive would not apply, and any gain or loss realized in the merger would be recognized for Italian tax purposes.

Italian Rules on EU Cross-Border Mergers

Italy implemented the EU merger directive (90/434/EEC) by way of Legislative Decree 544 of December 30, 1992.

More recently, Legislative Decree 199 of November 7, 2007, implemented EU directive 2005/19/EC, which amended and extended the EU merger provisions to EU PEs of EU companies. (The Italian Tax Code provisions that incorporate the merger directives are set forth in articles 178-181.)

According to those provisions, gains and losses realized on the transfer of the assets (including goodwill) of an Italian target company in a merger with an EU acquiring company are not recognized if, after the merger, the foreign acquiring company operates through a PE in Italy to which the assets and liabilities of the Italian target company are attributed. The Italian PE takes a carryover basis in the assets transferred in the merger and the recognition of gain or loss is deferred.

Definition of Permanent Establishment

Article 162 of the Italian Tax Code provides a definition of permanent establishment that is almost identical to the definition in article 5 of the OECD model income tax treaty.

Paragraph 4 of Tax Code article 162 contains a list of activities that do not constitute a PE even if they are carried out through a fixed place of business. The list corresponds to that in article 5, paragraph 3 of the OECD model.

Use of a PE for Planning Purposes

A PE can be used for several planning purposes under Italian law. For example:

- A PE is entitled to the tax exemption for dividends and gains from the sale of stock of Italian and foreign companies, and can consolidate other Italian companies under the Italian tax consolidation regime (offsetting profits and losses among the members of the group). However, dividends and gains from stock directly owned by a foreign company do not qualify for the participation ex-

emption, and a foreign company cannot consolidate directly owned Italian subsidiaries.

- Interest expenses allocated to a PE are deductible and can reduce the profits of consolidated Italian subsidiaries owned through that PE.
- Italian PEs may be entitled to tax treaty benefits or to the nondiscrimination protection of the EC Treaty as Italian domestic companies.

If the Italian activities of a foreign taxpayer are not sufficient to create a PE in Italy under the definition in the Tax Code (as was the case in ruling 21/E), tax benefits can be lost. Therefore, the actual existence of an Italian PE is an essential part of the planning strategy. ◆

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