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by Marco Rossi

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Practitioners' Corner

Italy's New Check-the-Box Rules

by Marco Rossi

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As part of the corporate tax reforms of 2003 that took effect in 2004, Italy has adopted new rules under which taxpayers can elect that domestic companies classified as corporations and subject to Italian corporate income tax be treated as fiscally transparent entities. Taxpayers can elect fiscal transparency simply by filing a form on which the appropriate box has been checked. Therefore, the new rules may be referred to as the Italian "check the box" rules.

The Italian check-the-box rules provide for two different types of fiscal transparency, each subject to different requirements. The first type of fiscal transparency applies to domestic companies treated as corporations and owned exclusively by domestic companies treated as corporations or foreign entities of any kind, each owning directly not less than 10 percent and no more than 50 percent of the stock of the entity measured by voting power and profits share. That type of fiscal transparency is governed by Tax Code section 115[1] and is commonly referred to as the "big transparency." The second type of fiscal transparency applies to domestic limited liability companies owned exclusively by no more than 10 (20 for limited liability cooperative companies) resident or nonresident individuals, earning no more than €5,164,569 (about US $6 million) in revenue in the prior tax year. That type of fiscal transparency is governed by Tax Code section 116 and is commonly referred to as the "little transparency."

Once fiscal transparency is elected, the effects are the same for both types. A domestic company for which tax transparency has been elected is no longer treated as a separate entity subject to corporate income tax. Instead the company's income or loss flows through to the company's owners, who are taxed on their distributive share of the company's taxable income in their separate or individual capacity.

The statutory provisions of Tax Code sections 115 and 116 have been followed by regulatory rules and extensive administrative guidance. On April 23, 2004, the tax administration issued a ministerial decree under Tax Code section 115(9).[2] On November 22, 2004, the tax administration issued a detailed circular (105 pages, plus attachments) that

[1]By "Tax Code" we mean the *Testo Unico sulle imposte sui redditi* ("Unified Text on Income Taxes") 917 of 1988 as amended, which contains the main provisions on personal and corporate income taxes. Other income tax provisions are included in many other statutes and regulatory materials.

[2]Ministerial decrees issued by the Ministry of the Economy under authority granted by the Parliament are binding on the tax administration and, in general, also on the taxpayers, who can challenge them if they are facially inconsistent with the statute. They can be considered analogous to the regulations issued by the U.S. Treasury Department under the Internal Revenue Code.

provides guidance on the application of the rules.[3] More recently, the tax administration has issued instructions on how to fill out and file the form required to elect fiscal transparency. Finally, a legislative decree designed to correct some minor aspects of the rules has been adopted by the government and is being approved by the Parliament.[4]

> ***A domestic company for which tax transparency has been elected is no longer treated as a separate entity subject to corporate income tax.***

We are sure the Italian check-the-box rules will never achieve the same recognition status and worldwide popularity of their U.S. counterparts, nor will they ever generate the same level of sophisticated tax planning techniques both at home and abroad. We are also aware that, beyond the same nickname, the similarities between the U.S. and Italian sets of rules are limited. Among the differences worth mentioning are that the Italian check-the-box rules work only in one direction, from separate entity status to fiscally transparent status. They also apply only to domestic companies, not to foreign companies (that is, to domestic or inbound investments), and they do not contemplate the notion of disregarded entity (or tax nothing). However, the Italian rules consent to elect fiscal transparency also to joint stock companies (*Società per Azioni* or SpA), commonly treated as corporations with no exception and on the list of the per se corporations in the U.S. regulations.

That being said, the Italian rules are — by Italian standards — significant. They represent a major departure from the general concept (common in Italy as well as in many other civil law jurisdictions) under which the classification of entities for tax purposes is linked to the entity's status for civil law purposes. They offer tax planning opportunities in a domestic context and have interesting implications also in the international context, especially from the U.S. perspective.

At the domestic level, electing fiscal transparency allows companies to avoid partial double taxation on corporate profits[5] and consolidate a subsidiary's losses with the parent's profits, and vice versa.

At the cross-border level, electing fiscal transparency offers all tax planning opportunities connected with the use of hybrids and reverse hybrids. From the U.S. perspective, the Italian check-the-box rules should attract the attention of U.S. multinationals to which they may offer new opportunities for foreign tax credit enhancement through the use of hybrids and foreign reverse hybrids on their Italian business operations — at least until the U.S. Treasury decides to revise the legal liability rule of reg. section 1.901-2(f)(1).

Part I of this article focuses on the big transparency, of interest for big corporate groups including foreign and U.S. multinationals. We discuss: (1) the general rules on classification of entities for tax purposes in Italy; (2) the requirements for the election; (3) how the election is made; (4) the consequences of the change in status of an entity; (5) the rules that apply to the new fiscally transparent entity; (6) the legal liability for the tax on the transparent entity's income; (7) the events that cause a termination of the election; and (8) the effect on the election of some reorganization transactions involving the transparent entity. Part II contains a review of the requirements that apply to the little transparency of interest for individual investors.

I. The Big Transparency

A. General Rules

Italian law lacks comprehensive rules on classification of entities for tax purposes. Classification of entities as corporations or partnerships derives indirectly from the provisions of the Tax Code. They establish which entities are treated as separate and subject to corporate income tax and which entities are not subject to tax, but whose income or loss flows through to their owners and is taxable to the owners in their individual or separate capacity. In general, entities that provide for unlimited liability for civil law purposes are treated as partnerships for tax law purposes — that is, they are not subject to tax on their income, which is attributed to the entity's

[3]Circulars issued by the tax administration illustrate the position of the tax administration on the statutory and regulatory provisions governing a matter and generally are given deferential treatment by the courts, although they are not strictly binding on either the tax administration or the taxpayers. They can be considered analogous to notices or other administrative general guidance issued in the United States by the IRS.

[4]The decree was approved by the government on March 18, 2005, and passed on to Parliament for final approval and enactment into law.

[5]Domestic or foreign dividends received by corporations are taxable at an effective tax rate of 1.65 percent that is equal to the corporate tax rate (33 percent) times the taxable amount of the dividend (5 percent). Dividends received by individuals are taxable at an effective tax rate that is the individual's marginal tax rate times the taxable amount of the dividend (40 percent) if dividends are distributed on qualified shares. Dividends are subject to a 12.5 percent flat rate withholding tax if distributed on nonqualified shares.

owners in proportion to their share of the entity's profits. Entities that provide for limited liability for civil law purposes are treated as corporations for tax law purposes — that is, they are subject to the corporate income tax.[6]

Classification of entities as partnerships for tax purposes derives from the provisions of Tax Code sections 5(1) and 6(3). Tax Code section 5(1) provides that the income of general partnerships (*Società in nome collettivo* or SNC) and limited partnerships (*Società in accomandita semplice* or SAS), whether or not distributed, is not taxed on the entity, but is attributed to each partner in proportion to the partner's share of the entity's profits and is taxed at the level of the partner.[7] Tax Code section 6(3) provides that the income of general partnerships and limited partnerships, from whatever source and whatever activity carried out by the partnership, is classified as business income and is taxed on the partners in accordance with the rules for taxation of business income earned by individuals. As a result of those provisions, entities that are organized as SNCs or SASs under civil law are treated as partnerships or fiscally transparent entities for Italian tax purposes.

Classification of entities as corporations derives from the rules of Tax Code section 73(1), which provides that the following entities are subject to Italian corporate income tax:

- resident SpAs, limited partnerships with stock divided by shares (*Società in accomandita per azioni* or SAPA), limited liability companies (*Società a responsabilità limitata* or SRL), cooperative companies, and mutual insurance companies;
- other domestic state or private commercial entities engaged in the conduct of a trade or business;
- other domestic state or private noncommercial entities, on their unrelated business taxable income (if any); and
- foreign entities of any type, with or without separate legal personality, regardless of their legal status, classification, and tax treatment under foreign law.

Therefore, domestic business entities organized as SpAs or SRLs for civil law purposes are automatically classified as corporations for Italian tax purposes. Most importantly, under Tax Code section 71(d), as commonly interpreted by taxpayers and the tax administration, all foreign entities, regardless of their legal form, classification, and tax treatment under foreign law, are classified and treated as corporations for Italian tax law purposes.[8]

Beyond the same nickname, the similarities between the U.S. and Italian sets of rules are limited.

In light of the above, it is clear that before the enactment of the check-the-box rules, Italian tax law did not allow flexibility in the classification of entities for tax purposes or any combination of limited liability and fiscal transparency. Classification of domestic entities was fixed and generally moved along the traditional lines of unlimited liability-fiscal transparency and limited liability-fiscal nontransparency, and foreign entities were treated as separate entities for tax purposes regardless of their form or tax treatment under foreign law.

B. Requirements for the Election

The requirements for the election of fiscal transparency are illustrated below. They must all be met on the first day of the tax year for which the election is made and without interruption throughout the entire election period (three years). If any of the requirements is not met on any day during the election period, the election is terminated generally starting the first day of the entity's taxable period during which the requirement was not satisfied.

[6]Here and in the rest of this article we use the terms "corporation" and "partnership" in accordance with their common meaning in U.S. (and international) tax language — that is, as synonymous for fiscally nontransparent (or separate taxable) entity and fiscally transparent entity, respectively.

[7]The SNC is a form of business organization whose owners have personal and unlimited liability for the entity's debts. The SAS is a form of business organization whose owners are divided in two categories: those with unlimited liability for the entity's debts and who are entitled to participate in the management of the entity (managing general partners); and those with limited liability, who cannot take part in the management of the entity (limited partners).

[8]Whether that is the exact meaning of that provision may be open to discussion. Section 73(1)(d) is to be read with sections 75 and 151, under which foreign entities are subject to corporate income tax in Italy only on their Italian-source income. Section 73(1)(d) is not a tax classification rule, and its purpose is not to classify a foreign entity as a corporation or partnership for all Italian tax law purposes, but only establishing — in combination with sections 75 and 151 — when and how a foreign entity is subject to corporate income tax in Italy. There are other rules elsewhere in Italian tax law that would seem to assume a foreign entity may also be classified otherwise. However, the most common reading of that provision is that all foreign entities are automatically and necessarily treated as corporations for all Italian tax law purposes, regardless of their organizational form and tax treatment under foreign law.

1. The Legal Form Requirement

The first requirement to elect fiscal transparency concerns the form of the entity and its owners for civil law purposes. Both the entity and all of its owners must be domestic entities organized in one of the forms referred to in Tax Code section 73(a) and subject to Italian corporate income tax. As stated above, those entities are SpAs, SAPAs, SRLs, cooperatives, and insurance companies. If an owner is an individual or a domestic business or nonbusiness entity organized in a different form, the election is not available. Most notably, an entity's owners may not include partnerships.

Before the enactment of the check-the-box rules, Italian tax law did not allow flexibility in the classification of entities for tax purposes.

As we see in section I.B.3., owners may include also nonresident entities. Then the legal form of the entity may be different from those enumerated above. We discuss that issue in the context of the discussion of the residency requirement.

2. The Ownership Requirement (10-50 Test)

Each entity's owner must own no less than 10 percent and no more than 50 percent of the entity's voting power and profits share. Voting power means the total number of votes that can be exercised at the ordinary meeting of shareholders (which elects the company's directors). Only voting rights and profit shares held directly by the entity's owners are included in the computation; no attribution, constructive, or indirect ownership rules apply. Therefore, the test can be easily met even when maintaining control or sole ownership of the entity, simply by owning the entity's stock through two commonly controlled entities. For stock possessing voting power or profits share not in proportion to the stock value, the computation is made with exclusive reference to the voting power and the profits share related to the stock directly owned by the owner.[9] If the stock is owned through a fiduciary company, the rules look through the fiduciary company to the beneficial owners. In that case, the fiduciary company must certify to the entity that the ultimate beneficial owners possess the requirements for the election. The entity must in its election form provide the tax administration with information about the fiduciary company, but need not provide information about the identity of the beneficial owners.[10]

Voting power or a profits share owned by a third party enters into the computation, but does not qualify to meet the test. Only voting power or a profits share owned by owners of the stock or capital interest on the entity (that is, by shareholders or members of the entity) can be relied on to meet the test. Therefore, if voting power or profits share in an entity is owned by a third party and the owners do not separately meet the 10-50 test based on voting power and profits share associated with their stock or capital interest in the entity, the election is not available and, if already in place, is terminated. Circular 49/E illustrates the rule with reference to the case of a usufruct, pledge, or seizure of stock to third parties as security for a claim. For a usufruct of the stock, the profits share related to the stock given in usufruct passes to the holder of the usufruct by operation of law, while the voting rights related to the stock are retained by the owner (together with legal title over the same). If, as a result of the usufruct, an owner relinquishes enough profits share to fall below the 10 percent minimum threshold, the test is not satisfied.

For a pledge of stock, both the voting rights and profits share related to the pledged stock pass on to the creditor by operation of law, unless the parties agree otherwise, and the pledger retains only the bare legal title of the stock. If, as a result of the pledge, the voting power and profit share held by the owner of the stock falls below the 10 percent minimum threshold, the test is not satisfied. The parties are free to agree that voting power or profits share related to the pledged stock are retained with the owner-pledger to continue to satisfy the test.

[9]The ability to issue disproportionate stock — that is, stock whose fair value, voting rights, and profits share are not necessarily equal and proportionate to the value of the property contributed by the owner — is provided for under Italian civil code sections 2348(2) for joint stock companies and 2468(3) for limited liability companies.

[10]Under Italian law, a fiduciary company owns stock in its own name but in the interest and for the account of others. In other words, it is a form of conduit in that it holds the bare legal title on the stock, while the beneficial ownership of the stock is owned by other persons in whose interest the conduit acts. The fiduciary rule adds simplification and privacy and offers additional opportunities for tax planning in the international context. For foreign tax law purposes, the Italian fiduciary may qualify as the owner of the transparent subsidiaries' stock, so that the chain of Italian transparent entities could be owned through a single Italian holding company. By electing to treat the subsidiaries as corporations and the fiduciary-holding company as a branch for foreign law purposes, foreign taxpayers could dissociate the taxable income that would remain with the lower-tier subsidiaries from the legal liability for the tax on that income that would be placed on the fiduciary-holding company under Italian law and rest on the foreign taxpayer for foreign tax law purposes. We discuss the issue of liability for the tax and its implication from the U.S. perspective in section I.F.

Finally, for a seizure of the stock as security for a disputed claim, the voting rights related to the seized stock pass to the custodian of the stock. If, as a result of the seizure, the owner of the stock no longer owns at least 10 percent of the entity's voting power, the test is not met.

Neither the statute nor the regulation nor the administrative guidance clarify whether any profit share related to financial instruments other than stock issued by an entity in favor of its owners or third parties are included in the computation for the 10-50 test.[11] Some uncertainty arises because, in phrasing the test, the statute refers to the percentage of profits of the entity and not to a percentage of entity's stock measured by profits share. No guidance can be derived from the rules that apply to the situations discussed above, because all of those situations concern profits shares regarding the entity's stock from which they have been dissociated and transferred to third parties; they do not concern profits shares originally pertaining to financial instruments that do not qualify as stock (held either by the entity's members or by third parties). We can assume a situation in which the entity X is owned by A and B, each owning an equal share of 50 percent of X's stock, voting rights, and total profits. B also holds financial instruments issued by X entitling B to a rate of return equal to 30 percent of the profits of the entity, payable with priority over A's and B's stock rights. X earns 100 of profits and, after paying 30 of those profits to B as return on the financial instrument, it distributes its profits (70) equally to A and B (35 apiece). The issue is whether, for the 10-50 test, the 30 of profits payable to B under the financial instrument held by B are included in the computation. If they are included, the test is not met, because B is treated as owning a percentage of the total profits of X equal to 65 percent, and that exceeds the 50 percent ceiling. If they are not included, the test is met because each A and B hold a 50 percent share of profits (and voting power) of X.

Computation problems may arise for stock with voting rights that are limited to specific matters or contingent on particular situations.[12] In those situations, computing the ratio of the limited or contingent voting rights over the total existing voting rights in an entity may be problematic. Similar problems may arise with stock that possesses a right to a share of the profits generated by a specific business activity of the company, as opposed to the company's total profits.[13] In that case, computing the exact ratio of a right to a share of a category of profits of the entity over the total rights to the entity's total profits may be difficult. For that, the rules on tax consolidation establish a presumption in which the limited profits share is deemed to be equal to the stock value.

Much to the dismay of Italian taxpayers — and their tax consultants — there can be no foreign hybrid entities under Italian tax law.

Voting rights temporarily suspended by operation of law are included in the computation. That is the case, for instance, for voting rights related to stock that the entity bought back or redeemed and holds as treasury stock or that is owned by the entity through a controlled subsidiary.

3. The Residency Requirement

Fiscal transparency can be elected only for domestic (resident) entities. For Italian tax law purposes, all foreign (nonresident) entities are classified and treated as corporations or fiscally nontransparent entities. Much to the dismay of Italian taxpayers — and their tax consultants — there can be no foreign hybrid entities under Italian tax law.[14]

The owners of a domestic entity seeking to elect tax transparency, however, may be either domestic

[11]Italian Civil Code sections 2346(6) and 2349 provide that joint stock companies may issue financial instruments that entitle the holder to a share of profits of the issuer but do not represent a capital interest in the entity and do not attribute the full legal status of shareholder, and therefore do not qualify as stock for general law purposes. These instruments are usually referred to as participating financial instruments. If the total remuneration paid or accrued under those instruments consists in a participation to the economic results of the issuing entity, the instruments would be classified and treated as stock for tax purposes under Tax Code section 44(2)(a).

[12]Section 2351 of the Italian Civil Code provides that a joint stock company's articles of incorporation may allow the company to issue stock with voting rights limited to particular matters or contingent on specific situations, if the value of that stock does not exceed half of the value of the total outstanding stock of the company.

[13]Section 2350 of the Italian Civil Code provides that joint stock companies may issue stock entitling the owner to a share of the profits related to a business activity carried out by the company, as opposed to the total profits of the entity. In that case, the articles of incorporation set out the rules to compute and account for the costs and revenues connected with that business activity, and the rights to profits generated by that business activity, that can be paid only to the extent of the company's total profits.

[14]From the Italian perspective, a foreign hybrid entity is a foreign entity classified as a partnership for Italian law purposes and as a corporation for foreign law purposes. We

(Footnote continued on next page.)

or foreign entities. Domestic entities must be organized in one of the forms referred to in Tax Code section 73(a). Foreign entities may be entities of any kind, like corporations, partnerships, or trusts. A foreign entity's legal form, classification, or tax treatment under foreign law is irrelevant in that case. For foreign entities, a major limitation applies to the ability to elect fiscally transparent status. The election can be made only if no Italian withholding tax would be due on dividends distributed by the domestic entity to its foreign owners, or if any withholding tax were due, it would be eligible for a total refund. None of the Italian bilateral tax treaties in force provides for a zero withholding tax on Italian outbound dividends. Thus, the Italian withholding tax on outbound dividends may not be due (or, if withheld, may be fully refundable) in two situations only:

- when the EC parent-subsidiary directive applies to exempt dividends paid by an Italian subsidiary to its EU parent[15] from withholding tax; or
- when the stock in the Italian entity is owned by a foreign entity (whether resident in the European Union or in a third country) through a permanent establishment in Italy to which that stock is related.[16]

In the first situation, according to the 1990 EC directive, dividends paid by an Italian subsidiary to its parent would be exempt from Italian withholding tax (or the withholding tax would be refundable) if the parent company:

- is resident for tax purposes in an EU member state;
- is organized in one of the forms listed in the attachment to the Directive 435/90/ECC of the council dated July 23, 1990 — that is, in the form of a corporation or separate taxable entity;
- directly owns at least 25 percent of the stock of the distributing subsidiary and has owned that stock for at least one year without interruption at the time of the dividend distribution; and
- is subject to corporate income tax in its resident country, without benefiting from exemption or elective regimes, unless they are temporarily or geographically limited.

EC Directive 2003/123/CE, published in the EC official gazette 7 of January 13, 2004, will change the rules of the 1990 EC directive on the exemption of EU cross-border dividends from withholding tax in some important respects. The 25 percent holding requirement will be reduced over time to 15 percent starting January 1, 2007, and to 10 percent starting January 1, 2009. The withholding tax exemption will apply also to dividends paid to a permanent establishment located in an EU country of a parent company resident in another EU country. The limitation on the ability to elect fiscal transparency by nonresident shareholders, set forth regarding the rules of the EC parent-subsidiary directive, results in a discrimination against nonresident owners that are subject to stricter requirements than those that apply to resident owners. For nonresident owners established in an EU member state, that discrimination may be deemed to violate the EC Treaty.[17]

The second situation in which outbound dividends are exempt from Italian withholding tax concerns dividends paid to a foreign taxpayer's Italian permanent establishment (owned either by an EU or non-EU entity). Then the dividends are income of the Italian permanent establishment and are subject to tax in Italy on a net basis at the corporate tax rate. For that purpose, the stock on which dividends are paid must be carried on the books of the Italian permanent establishment and must be connected with the permanent establishment's business.[18] However, under the new participation exemption rules, 95 percent of the amount of that dividend would be exempt from corporate income tax, and only 5 percent would be taxable income of the Italian permanent establishment.

In light of the above rules, a foreign entity that is resident in a non-EU country has two options to preserve its ability to elect fiscal transparency for its Italian subsidiaries. The first option is to hold the stock in its Italian subsidiaries through EU holding companies. In that case, attention must be paid to an antiabuse rule under which the exemption from withholding tax applies also to dividends paid to a EU parent company that is directly or indirectly controlled by one or more shareholders resident in a non-EU country, if the EU parent company can furnish sufficient evidence that it has not been

assume without further discussion that the common reading of Tax Code section 73(d) is correct. On that issue, see footnote 8 above.

[15]*See* article 27-*bis* of Presidential Decree 600 issued on September 29, 1973, that enacted the part of the EC parent-subsidiary directive on the withholding tax on outbound EU dividends.

[16]*See* article 27(3) of Presidential Decree 600 issued on September 29, 1973.

[17]One may also ask if that limitation violates the tax treaty nondiscrimination provisions. A more thorough discussion of that issue is beyond the scope of this article.

[18]Italian law treats a permanent establishment like a resident corporation and subjects income connected with the permanent establishment business to corporate income tax under the same rules that apply to domestic corporations.

established for the exclusive or principal purpose of benefiting from the exemption.[19]

The second option is to hold the stock of the Italian subsidiary through a permanent establishment in Italy. In that case, under the participation exemption regime, dividends paid to the Italian permanent establishment on that stock would be substantially exempt from the net tax on the permanent establishment's income.[20] Because Italy has no branch profits tax, those dividends would escape Italian taxation. The books and records of the permanent establishment are relied on to determine whether the stock is effectively connected to the Italian permanent establishment's business. If the stock is properly reflected on the books and records of the permanent establishment, as a result of the combination of the permanent establishment and the participation exemption rules, no withholding tax would be due on dividends paid to the permanent establishment on that stock, no net tax would be due on the dividend income of the permanent establishment, and the foreign entity could elect fiscal transparency. In the absence of a branch profits tax, no Italian tax would be due on the repatriation of those dividends to the head company. Therefore, a foreign entity is potentially able to convert outbound dividends subject to Italian withholding into dividend income not subject to any withholding tax or net tax on the permanent establishment just by holding the stock on which those dividends would be paid through an Italian permanent establishment, while at the same time preserving its ability to elect fiscally transparent treatment. That would require as little as establishing an office in Italy and carrying the stock on the permanent establishment's books and records.

After the enactment of the participation exemption rules, the Italian tax administration might want to address more directly the situations when an Italian permanent establishment may be used for tax avoidance purposes. That may include more scrutiny of the use of an Italian permanent establishment to preserve a foreign taxpayer's ability to elect fiscal transparency. There are at least two statutory authorities that may authorize that kind of inquiry. The first authority is found in art. 37-*bis* of Presidential Decree 600 of 1974. Under that, the way in which some assets, such as stock and other financial instruments, are carried and classified on a taxpayer's books can be challenged by the tax administration and be denied effect for tax purposes if it lacks economic substance and its only purpose is avoiding taxes or obtaining tax benefits otherwise not due. The second authority is found in art. 27(3) of Presidential Decree 600 of 1974, which sets out a related test that would seem to mandate a facts-and-circumstances analysis to determine whether there is a real economic and substantial relationship between the stock and the permanent establishment that justifies the stock being carried on the PE's books. There is still no specific case law or administrative guidance on that issue. Taxpayers must be careful in planning their transactions and must be ready to explain the business reasons for them.

C. Filing of the Election

The election requires previous approval by all of the owners of the entity and is effected in two steps. First the owners notify the entity of their consent to the election in a registered letter. Second, the entity makes the election by filing with the tax administration a form on which it has previously checked the appropriate box.

> ***The election is binding for three of the entity's tax years and is not revocable.***

The form must be filed by the end of the entity's tax year for which the election is made, and, once filed, the election takes effect the first day of that tax year. The election is binding for three of the entity's tax years and is not revocable. Once the election expires, a new one must be made in the same way, before the end of the entity's first tax year immediately following the expiration of the election to renew the fiscally transparent status for an additional three-year period.

The rules do not clarify whether making the election requires a shareholders' resolution or just a decision of the board of directors. Because all shareholders must consent to the election, in the absence of clearer guidance, a resolution by the meeting of shareholders is practical and advisable.

D. Causes of Ineligibility

The election cannot be made if the entity is part of a tax consolidation group for the same taxable periods. The entity's owners can elect fiscal transparency for their subsidiaries and still elect tax consolidation together with other affiliated corporations for the same taxable periods.

The election also cannot be made when the owned entity has issued any participating financial instruments referred to in Tax Code section 2346(6). Those are financial instruments other than stock that can be issued in exchange for contribution of property or services, and they entitle the owner to a share of

[19]Article 27-*bis*, paragraph 4 of Presidential Decree 600 of 1973.

[20]Actually, 95 percent of the dividends would be tax-exempt.

profits and may also grant administrative rights, including the right to appoint a member of the board of directors. They do not entitle the holder to share in net assets upon liquidation and exercise control and do not incorporate full shareholder rights and status. The decree for approval before Parliament would eliminate the provision enabling companies that issued that kind of instrument to elect fiscal transparency.

Finally, the election cannot be made if the entity has filed for bankruptcy protection.

If an election is already in place when any of the aforementioned events occur, the election would be terminated effective the first day of the taxable period during which the terminating event occurred.

E. Operative Rules

1. In General

Instead of classifying the entity as a partnership for all tax purposes and referring to the partnership tax rules to determine the tax treatment of the entity that elected tax transparency, the Italian check-the-box rules provide their own substantive rules that govern the tax treatment of an entity that elected fiscally transparent status under the check-the-box regime. Those rules essentially provide that the entity's income flows through to the owners and is taxed at the owners' level. That concept is at the core of the partnership tax treatment. The law that granted the government authority to issue the check-the-box rules refers to the ability for domestic companies taxed as corporations to elect to be treated as partnerships for tax purposes. Circular 49/E refers often to fiscally transparent status, traditionally available only to partnerships, but now extended to corporations owned by other corporations. A commonly accepted view is that, when appropriate, the rules on the taxation of partnerships may be applied by analogy. Therefore, it may be concluded that as a result of the election, an entity previously classified and taxed as a corporation is treated as a partnership for tax purposes. However, because the rules do not classify that entity as a partnership for all tax purposes, unless otherwise provided in the rules, an entity that elected fiscal transparency is still treated as a corporation for all other tax purposes. That means, for instance, that the reorganization provisions that typically apply to corporations continue to apply also to entities that elected fiscal transparency under the check-the-box rules and that would be treated as corporations for that purpose.[21] The way in which the Italian check-the-box rules operates is therefore fundamentally different from the U.S. check-the-box rules, whose effect is exclusively that of determining the tax classification of an entity whose substantive tax treatment is then governed by the rules of subchapter C or subchapter K of the IRC.

2. Computation and Allocation of a Transparent Entity's Taxable Income

The entity must compute its taxable income and file an informational return. The entity's income is computed in the same way as the taxable income of corporations. The tax character and treatment of the income is determined at the entity's level. The entity's owners must report their share of the entity's taxable income and losses on their own income tax returns and are taxed accordingly in their separate capacity. An owner must include its distributive share of the entity's (bottom line) taxable income for any tax year of the entity ending with or within the owner's tax year. The owner's distributive share of the entity's income is characterized as business income at the owner's level.[22] The entity and its owners may have different tax years. There are no restrictions on the choice of the entity's tax year or that prescribe a required tax year for the entity to avoid deferral of income inclusion by the entity's owners.[23] Only those that are owners on the last day of the entity's tax year are subject to income inclusion, in accordance with their distributive share of the entity's income as measured at that time. An owner's distributive share of the entity's income is determined in accordance with the owner's profit participation as set out in the company agreement.[24] For computing an owner's distributive share of the entity's income, a change in profit or loss participation during the tax year as a result of a transfer of stock from one owner to another owner takes effect the immediately following tax year. A change in profit or loss participation as a result of a transfer of stock to a third party takes effect the first day of the

[21]Tax Code sections 170-177 on domestic transformations, mergers, spinoffs, and corporate contributions, and sections 178-181 on cross-border mergers do not exempt entities that

(Footnote continued in next column.)

elected fiscal transparency under the check-the-box rules. Those rules do not directly or indirectly prohibit a fiscally transparent entity from engaging in that type of transaction.

[22]More precisely, income from participation in partnerships (or other tax transparent entities), which can be offset only with business losses or losses from participation in partnerships (or other tax transparent entities) and not with investment or passive income.

[23]Reference is made to the rules of IRC section 706.

[24]The owner's share of profits need not be equal to the owner's share of losses and in proportion to the owner's capital interest. In other words, Italian law permits a different allocation of a company's income and losses among its owners that may be even nonproportional to the owner's capital contributions to the company. *See* Italian Civil Code section 2348 on joint stock companies and section 2468 for limited liability companies.

tax year in which it occurs.[25] A foreign owner's distributive share of the transparent entity's taxable income is Italian-source business income taxable in Italy on a net basis.[26]

3. Treatment of Distributions of Transparent Profits

Distributions of an entity's taxable or tax-exempt profits earned during the transparency period (transparent profits) are nontaxable to the entity's owners, but reduce the owners' adjusted tax basis in their company's interests (as seen below). If there are both transparent and nontransparent profits, the rules establish a rebuttable presumption under which, in the absence of a different determination at the time of the distribution, the distribution is deemed to come first out of transparent profits (and therefore is nontaxable) until they are used up, and then out of nontransparent profits for any excess. An entity's distribution of appreciated property is taxable at the entity's level in that it generates a taxable gain (characterized as capital gain or ordinary income based on the character of the underlying property) that is attributed pro rata to the entity's owners.

4. Allocation of Transparent Losses

An entity's net (bottom line) fiscal losses incurred after the election (transparent losses) are allocated to the entity's owners in proportion to their participation to the entity's losses as determined in the entity agreement,[27] but only to the extent of each owner's share of the entity's net worth (gross assets minus liabilities) at book value.[28] For that purpose, the entity's net worth is not diminished or is computed without regard to current operating losses[29] and include any equity contributions made by an owner during the current tax year. The part of the loss exceeding the entity's net worth that is not allocable to the entity's owners is carried over by the entity and offset by the entity's taxable income of future years in accordance with the rules that apply to corporations.[30] Net losses allocated to the owners maintain the tax status that they had at the entity level.[31] The rules provide for a nonrebuttable presumption that the entity's net loss carryovers offset first the entity's transparent profits and then the entity's nontransparent profits, if any. The owner's distributive share of the entity's taxable income is characterized as business income and can be offset only with business losses or losses from participation in other partnerships or fiscally transparent entities.

5. Allocation of Tax Credits and Withholding Tax Payments

The transparent entity also allocates to its owners, in proportion to their share of profits, any tax credits, including credits for taxes paid to foreign countries and withholding taxes paid. If the entity earns foreign-source income on which it pays income taxes to a foreign country, an entity's foreign owner benefits from a foreign tax credit, which offsets the Italian tax due on its distributive share of the entity's income.

6. Outside Basis Adjustments

The owner's outside basis is increased by the amount of the owner's distributive share of the entity's taxable income and decreased by the amount of any distribution of the entity's profits from the entity to the owner, but only to the extent of the taxable income included by the owner resulting in basis increase. Conversely, the owner's outside basis is decreased by the amount of the owner's distributive share of the entity's fiscal loss and is increased by the amount of any equity contributions made by the owner to the entity.[32] That the basis is adjusted (upward and downward) only on the owners' distributive share of taxable income or deductible losses may result in taxation of otherwise tax-exempt income or deduction of an otherwise nondeductible loss. Those rules, combined with the rule referred to in the preceding paragraph under which the entity's losses do not flow through to the owner to the extent that they exceed the owner's

[25]That analysis is confirmed by para. 3.10 of Circular 49/E.

[26]Tax Code section 23(g).

[27]That need not necessarily coincide with the owner's share of profits or the fair market value of the owner's capital interest in the entity, as illustrated in footnote 13.

[28]That rule resembles the rule of IRC section 704(d) that limits a partner's deduction for her distributive share of the partnership's losses by the partner's adjusted basis in her partnership interest.

[29]In other words, the entity's current operating loss is added back to the calculation of the net worth value to determine the portion of the loss that can be allocated to the owner and the portion of the loss that remains with the entity, if any.

[30]Those rules are set out in Tax Code section 84 and provide for a five-year carryover period and no carryback, except that losses incurred in the first three taxable periods can be carried over indefinitely.

[31]Therefore, losses incurred in the entity's first three tax years can be carried over indefinitely by the owner even if attributed to the owner in a fiscal year following the owner's third taxable year.

[32]Those rules are significantly different from the rules of IRC section 705 that require that a partner increase her adjusted basis also by her share of the partnership's tax-exempt income and decrease her outside basis also by her share of the partnership's nondeductible losses.

share of the entity's net worth, should prevent the possibility of a downward basis adjustment below zero.

F. Legal Liability for the Tax on the Transparent Entity's Income

Tax Code section 115(8) provides that the entity is jointly and severally liable with its owners for the tax due on its taxable income, plus interest and penalties. That provision, however, has been limited by the provisions of articles 12 and 13 of the ministerial decree 101 of 2004. Article 13 of the ministerial decree provides that joint and several liability is excluded in the cases referred to in article 12(1), as well as when an owner fails to pay the tax due on its distributive share of the entity's taxable income. Art. 12(1) refers to when an owner fails to report its distributive share of the entity's taxable income in its own tax return.

As a result of the combination of statutory and regulatory provisions, it appears the entity's owners are exclusively and separately liable for the income tax due on the entity's taxable income. It also appears that the tax administration cannot go after the entity if any of its owners either fails to report its distributive share of the entity's income or duly and timely pay the income tax owed. The entity may be liable only when it fails to properly report its income on the informative return it must file with the tax administration, and on the basis of which the owners include their share of the entity's taxable income and are subject to tax on it. However, that is a case of exclusive and direct liability of the entity, which bears no relation to the liability on the owners for the tax on their share of the entity's taxable income. There is no doubt that Italian law places the liability for the tax on the entity's taxable income solely on the entity's owners, who must pay that tax in their separate capacities.

From the U.S. perspective, that the local tax is imposed on the owners of the entity — and that the entity bears no liability for the tax — makes the owners the technical taxpayers for foreign tax credit purposes.[33] If the entity is treated as a separate corporate entity for U.S. tax purposes (that is, it is a foreign reverse hybrid), its income is not subject to U.S. tax until it is distributed to the owner. Thus, if the owner is a U.S. person, he will have foreign tax credits for income that he has not yet included for U.S. tax purposes. U.S. taxpayers in excess limitation positions can use that foreign reverse hybrid strategy to reduce U.S. residual tax on other foreign-source income.[34]

G. Consequences of Change in Status

Under U.S. tax law, conversion of a corporation to a partnership is treated as a liquidating distribution of assets by the corporation to its shareholders (assets up) followed by a contribution of those assets by the shareholders to the new partnership. Conversely, conversion of a partnership to a corporation is treated as a transfer of assets by the partnership to the new corporation solely in exchange for the corporation's stock (assets over) followed by a liquidating distribution of that stock by the partnership to the partners. None of those notional transactions is deemed to occur under Italian law. The Italian rules adopt a static approach based on the concept that the election does not affect the tax treatment of preelection nontransparent profits and losses that remain subject to the ordinary rules applicable to corporations. Also, the expiration or termination of the election does not affect the tax treatment of posttermination distributions of transparent profits that remain subject to the tax transparency rules. The rules also provide for adjustments to be made to the change in status to avoid a double deduction of the same losses. Those aspects are discussed in more detail below.

1. Postelection Distributions of Nontransparent Profits

Postelection distributions are subject to the ordinary rules on corporate distributions to the extent that they are distributions out of the entity's profits accumulated before the election, when the entity was treated as a corporation (nontransparent profits). When there are both nontransparent and transparent profits, the rules presume that a distribution is made first out of transparent profits and then out of nontransparent profits, unless it is otherwise declared at the time of the distribution. Among the rules on corporate distributions that apply to distributions of nontransparent profits are the provisions of Tax Code section 47 under which any distribution is a taxable dividend to the extent of current and accumulated earnings and profits, a tax-free return of capital reducing the shareholder's basis in the stock to the extent of capital reserves, and a capital

[33]Under IRC reg. section 1-901-2(f)(1) (the so-called technical taxpayer rule), which provides that "the person by whom tax is considered paid for purposes of sections 901 and 903 is the person on whom foreign tax imposes legal liability for such tax, even if another person (e.g., a withholding agent) remits such tax."

[34]For a discussion of the use of hybrid and reverse hybrid techniques to enhance the U.S. foreign tax credit, the authorities that address foreign tax credits for hybrid entities, and a proposed revision of the technical taxpayer rule of section 1.901-2(f)(1), see the New York State Bar Association's report, "Revising the U.S. Reg on the Allocation of Foreign Taxes Among Related Persons," *Tax Notes Int'l*, June 13, 2005, p. 989.

gain for any remaining portion exceeding the shareholder's basis in the stock.[35] Therefore, if an entity has both transparent and nontransparent profits, a distribution made by the entity to its owners:

- in the absence of any statement to the contrary, is deemed to be made out of transparent profits and is treated as a nontaxable distribution;
- if the entity declared that it is made out of nontransparent profits, is treated as a taxable dividend to which Tax Code section 89 applies; and
- if the entity declared that it is made out of capital reserves, is treated as a taxable dividend to the extent of nontransparent profits and any excess is treated as a tax-free recovery of capital to the extent of the owner's adjusted tax basis in the stock or a capital gain for any excess thereof under the rules of section 47.

2. Distribution of Transparent Profits After Termination of the Election

Distributions made after a termination of the election of profits accumulated during the election are treated as nontaxable distributions of transparent profits. They are tax-free, as if the transparent status were still in place, if the distributee is a company that could elect fiscal transparency under section 115.

3. Nontransparent Losses

Losses incurred before the election (nontransparent losses) do not flow through, but can be used by the entity only to offset taxable income of future years in accordance with the corporate net loss carryover rules.[36]

4. Advance Tax Payments

On the first and last year of the election, the entity must make the advance payment of the tax due for the current year in accordance with the ordinary rules.[37] Those payments are allocated to the owners and offset the tax eventually due by the owners on their distributive share of the entity's taxable income for that year.

5. Special Adjustments

Before the tax reforms of 2003, a company owning stock in another company could write down the book value of its stock in the company on its books if the value of the stock had decreased as a result of losses recognized by the owned company for book purposes in the current year, even if those losses were deferred to future years for tax purposes, and the company could recognize a current tax loss on that stock.[38] Without any special rule applicable for the election for tax transparency, after the election the new transparent company would be able to recognize the deferred losses for tax purposes, thereby reducing the taxable income or generating a loss that would flow through to its member, which in the end would benefit from the same loss a second time. To avoid that result, the rules require that an owner that recognized tax losses on its stock in the new transparent entity under the above regime, before the election, adjust the book items of the new transparent entity for an amount equal to the lesser of the aggregate of previously recognized losses (net of any recognized gains) on that stock or the entity's financial losses that generated the losses recognized by the owner on that stock. When the new transparent entity deducts the loss for tax purposes during the election period, as a result of those special adjustments, the owner will increase its distributive share of the entity's income or will reduce its distributive share of the entity's loss, thereby recapturing its previously recognized losses on the entity's stock. The rules require that the owner look back 10 years before the election and provide for some complex calculations and formulas to make the adjustments. The adjustments apply only to an owner that recognized net losses on the stock of the entity under the old rules.

H. Termination of the Election

The events that may cause a termination of the election and a return to the non-fiscally-transparent status may concern either the entity's owners or the entity itself.

1. The Entity's Owners

The situations that concern the entity' owners are:

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[35]Those provisions resemble the rules of IRC section 301. Tax Code section 47(1) establishes a nonrebuttable presumption that any distributions come first out of the profit reserves and then out of capital reserves. Tax Code section 47(5) provides that a distribution out of capital reserves is tax-free and reduces the shareholder's adjusted basis in the stock. Tax Code section 87(5), with reference to section 47(5), provides that any excess of the amount of the distribution over the shareholder's basis in the stock is a capital gain.

[36]Which provides for a five-year carryover period and no carryback.

[37]The general rule is that a payment on account of the corporate income tax due on the income of the current year must be made during the current year for an amount equal to 99 percent, now increased to 102.5 percent, of the tax paid on the taxable income of the previous year. The taxpayer can make a reasonable estimate of the tax due for the current

(Footnote continued in next column.)

year and pay that amount, but it is liable for interest and penalty surcharge in case of any underpayment.

[38]That is no longer possible after the 2003 tax reforms. A loss can be recognized for tax purposes only if it is realized from the sale or exchange of the stock. Even in that case, a realized loss is nondeductible if a gain on the stock would be nontaxable under the participation exemption rules.

- a change in the voting power below 10 percent or above 50 percent;
- a change in the profits share below 10 percent or above 50 percent;
- a transfer of fiscal residency abroad with withholding tax obligation on dividends; and
- a transformation into an entity of a type or legal form not eligible for the election.[39]

If an owner is transformed into an entity with a different legal form or status, but is still eligible for the election, the election is unaffected.[40] Also, if an owner becomes a tax resident of an EU member state, or of a foreign country but with a permanent establishment in Italy that owns the stock of the transparent entity, the election is unaffected.[41] A sale of stock does not affect the election if, after the sale, each owner still owns voting power and profits share falling within the prescribed 10-50 range.

Losses incurred before the election (nontransparent losses) do not flow through.

It is sufficient that any terminating event occurs at any time during the three-year election period to terminate the election; then the election is terminated the first day of the tax year in which the event occurred. The entity must inform the tax administration of the termination within 30 days after the terminating event.

2. Entity

The situations that concern the transparent entity are the following:

- issuance of participating financial instruments governed by Tax Code section 2346(6);[42]
- filing for bankruptcy protection;
- transformation into a type of entity for which fiscal transparency is not allowed;[43]
- transfer of fiscal residency abroad; and
- merger or spinoff, unless all the requirements for the election are still met and the election is confirmed by all the owners after the transaction.

3. Effects of the Termination of the Election

When one of the aforementioned events occurs, the election is terminated the first day of the tax year in which the event occurred. Special rules apply for termination of the election because of a reorganization of the transparent entity. Those are discussed in section I.I. During the termination year, the entity is treated as a corporation subject to corporate income tax, unless and until a new election is made. That means the profits or loss of that year shall be treated as nontransparent and the entity must make the advance payment on its tax for the year. All the rules illustrated in sections I.E. and I.G. on the treatment of transparent and nontransparent profits and losses will apply. There are no other tax consequences connected with termination of the election. Therefore, although the election is binding for a period of three years, taxpayers can freely move in and out of fiscally transparent status. The tax administration acknowledged that in the circular, but said it will make inquiries based on the facts of each case to see whether continuing changes in status are motivated solely by tax avoidance purposes.

I. Reorganizations

1. Bankruptcy, Transformation, and Transfer of Fiscal Residence

If the transparent entity files for bankruptcy protection, the election is terminated on the filing date. If the transparent entity is transformed into a company classified as a partnership for tax purposes, the election is terminated the day the transformation takes effect. If the transparent entity is transformed into a type of corporate entity different from those eligible to elect fiscally transparent status, the termination of the election is retroactive to the first day of the tax year.[44] If the transparent entity moves its fiscal residence to a foreign country, the election terminates on the day the change of residence takes effect. Circular 49/E provides at paragraph 2.17.3 clarifications to determine the last

[39]A transformation under Italian law is a transaction as a result of which an entity of a type is reorganized into an entity of different form or legal status. That transaction does not trigger tax consequences if both the old and new entity are classified as a corporation for tax purposes (*e.g.*, a change of an SpA into an SRL, that are both treated as corporations for tax purposes). Instead it triggers specific tax consequences if the old and the new entity have a form that is classified differently for tax purposes and there is passage from partnership to corporate tax status or vice versa (*e.g.*, a transformation of an SpA that is a corporation for tax purposes into an SNC that is a partnership for tax purposes).

[40]*E.g.*, conversion of an SpA into an SRL or vice versa.

[41]In those cases there would not be withholding tax on dividends paid from the Italian entity to the new foreign owner, and the foreign owner would still be entitled to the election, and an already-made election remains valid.

[42]That situation will be eliminated by the amending decree under approval by Parliament.

[43]*E.g.*, a change into partnership status or transfer of fiscal residency abroad.

[44]There are no apparent reasons for the different treatment of those two situations.

day of residence that may be relevant also for general tax purposes. Circular 49/E refers to the general rule on fiscal residence of corporations under which a corporation is resident in Italy for tax purposes if, for most of the tax year (that is, for at least 183 days) it has in Italy its registered office, its place of management, or its principal place of business.[45] Then the circular uses an example to illustrate the rule. Assuming a company uses a calendar year, with transfer of its residence abroad on March 3, 2007, the election terminates on January 1, 2007. With transfer of its residence abroad on September 8, 2007, the company is resident in Italy for tax purposes through the end of the tax year (that is, December 31, 2007), and the election terminates on the last day of the tax year. The company's income is taxed on a transparent basis through that date. That illustration confirms that with change of residence, the last day of residence is either the first or the last day of the tax year, depending on whether the change occurs in the first or the second half of the tax year.

2. Mergers and Divisions

If the transparent entity is merged into an existing or newly formed entity, the election terminates on the day the merger takes effect, regardless of whether the acquiring entity is eligible for tax transparent treatment.[46] If an existing or newly formed entity is merged into the transparent entity, the election is unaffected if all the owners of the entity, including the former owners of the merged entity, confirm the election using the same procedure used to make the original election.[47] If the election is not confirmed, it is terminated on the first day of the tax year.

If the transparent entity transfers all of its assets to an existing or newly formed entity in exchange for stock of that entity and distributes that stock to its owners in complete liquidation and goes out of existence (split-up), the election terminates on the day the transaction takes effect, regardless of whether the acquiring entity is eligible for fiscally transparent treatment. Of course, the acquiring entity can make a new election. If the transparent entity transfers only part of its assets and distributes the stock of a subsidiary remaining in existence (split-off), the election is unaffected if confirmed by all owners as described. If the election is not confirmed, it is terminated the first day of the current tax year.

For the little transparency, all other termination events discussed for the big transparency apply mutatis mutandis.

If the transparent entity acquires all of the assets of another entity in exchange for its stock and the owners of the acquired entity receive stock of the transparent entity in exchange for their stock in the acquired entity, the election is unaffected and there is no need to confirm it.

3. Liquidations

If the transparent entity is liquidated, the election remains in place. However, for computing the three-year election period, the period between the beginning of the tax year and the opening of liquidation counts as one taxable period. According to the general rule, the entire liquidation period counts as one taxable period.

II. The Little Transparency

A. Introduction

The special election of fiscal transparency for small limited liability companies is subject to the same substantive rules that apply to the big transparency, except different requirements must be met to be eligible for that type of fiscally transparent treatment, and a special cause of ineligibility applies.

That special regime is conceived as an ad hoc option for small individually owned business that can adopt fiscal transparent treatment while maintaining the benefit of limited liability, thereby avoiding the double tax on dividends and capital gains.[48]

Under the rules, a limited liability company may also be used as a holding company to own portfolio

[45]The same rule applies to partnerships. Individuals are resident in Italy for tax purposes if for the most part of the fiscal year (*i.e.*, for at least 183 days, even if nonconsecutive). Alternatively, they are resident in Italy if they registered on the official list of the population living in Italy, they have in Italy their domicile (*i.e.,* the principal center of their affairs and interests), or they have in Italy their residence (*i.e.*, their principal place of living). In all cases, the 183-day rule applies to determine the first and last day of residence.

[46]In that case, the merged entity is deemed to go out of existence and the acquiring entity does not step into the shoes of the merged entity for election purposes.

[47]In that case, the merged entity is deemed to go out of existence and the acquiring entity's election remains in place but needs to be confirmed by the old and new owners of the entity.

[48]Forty percent of dividends or capital gains on the sale or exchange of qualified stock held by individuals is taxable at the individual statutory graduated rates, while 60 percent is tax-exempt.

investments in stock with a significant tax advantage, so that by electing fiscal transparency, dividends that would be taxable on 40 percent of their amount at the individual investor level would be converted into dividends taxable on 5 percent of their amount if earned through a transparent company. The draft decree that is pending in Parliament is expected to shut down that form of tax arbitrage.

B. Requirements

The requirements to elect fiscal transparency under that special regime are as follows:

- the participating company must be an SRL or a limited liability cooperative company (SCARL);
- the company's members must be individuals, either resident or nonresident, but if nonresident only if no withholding tax would apply on dividends distributed from the company to the nonresident member;[49]
- the number of members cannot exceed 10 for SRLs or 20 for SCARLs;[50]
- the company's revenue for the immediately preceding tax year cannot exceed €5,164,468.99 (or 10 billion of old Italian lire);[51] and
- the company cannot own shares eligible for exemption of dividends and gains under the participation exemption rules.[52]

If the stock is owned by a fiduciary company, the rules look through the fiduciary company to the ultimate beneficial owners. In that case, the fiduciary company must certify the numbers of the beneficial owners and, if there are nonresident owners, must certify that no withholding tax applies. The entity in turn must notify the tax administration of the fiduciary company and the number of the beneficial owners.

The ratio of the participation exemption eligibility exclusion is to avoid tax arbitrage transactions through which an individual, instead of owning stock directly, the gains from the sale of which would be taxable up to 40 percent of their amount, owns the stock through a fiscally transparent SRL, thereby obtaining total tax exemption of the gains under the participation exemption regime.[53] Because exemption of corporate dividends is subject to none of the requirements that apply to exemption of gains, that form of tax arbitrage is still available for dividends. The draft decree awaiting approval in Parliament would prevent that form of tax arbitrage by providing that dividends and gains earned by the fiscally transparent company shall be separately stated and their tax treatment determined at the individual owners' level.

C. Termination of the Election

If the revenue ceiling is exceeded, the election is terminated the first day of the immediately following tax year. If any other requirement is not met, the election is terminated the first day of the tax year in which the requirement is not met. For the little transparency, all other termination events discussed for the big transparency apply *mutatis mutandis*.

III. Conclusion

The Italian check-the-box rules are burdensome and require additional and substantial compliance work from taxpayers. That may be a reason only a few companies have elected fiscal transparency so far. However, they also offer important tax planning opportunities both at the domestic and the international level. Depending on the value of possible tax savings at stake, it may be worth exploring them in depth and inquiring what kind of benefits they can bring to a transaction. ◆

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[49]The only situation when no withholding tax applies to dividends distributed to nonresident individual shareholders is when the nonresident recipient owns the stock in the Italian company through a permanent establishment in Italy to which the stock is related.

[50]No minimum or maximum stock ownership is required. Therefore, the company can also be wholly owned.

[51]As resulting from the income tax return filed for the immediately preceding tax year. Revenue does not include ordinary income from the sale of stock, debt obligations, or other financial instruments held as inventory by a security dealer. If additional revenue is assessed by the tax administration in an audit bringing the total revenue above the limit, the test is not met. Newly formed companies can always elect fiscal transparency. For companies formed during the preceding tax year, the calculation is made pro rata.

[52]Unless ownership of those shares is mandated by law or the shares cannot be sold or disposed of.

[53]Tax treatment of the gain would be determined at the company level and the gain would be tax-exempt at the company level under the participation exemption rules and pass through to the individual member as tax-exempt income. If realized directly by the individuals, the same gain would be taxable on 40 percent of the amount. That result might be avoided if the rules required that that type of income be separately stated and subject to the tax treatment determined at the individual member level. (*See* IRC section 702(a) and regulations thereunder.)