taxanalysts
Respectfully disagreeable since 1970.

tax notes international

VOLUME 49, NUMBER 4 ■ JANUARY 28, 2008

Officials Grapple With Corporate Tax Residency Issues

by Marco Rossi

Reprinted from *Tax Notes Int'l*, January 28, 2008, p. 334

taxanalysts tax notes international

Officials Grapple With Corporate Tax Residency Issues

by Marco Rossi

Italy's tax administration, with resolution 312/E of November 5, 2007, refused to issue under Italy's new anti-inversion rules and the general corporate tax residency provisions of the Italian Tax Code a ruling on the tax residency of an Italian-owned Dutch holding company that controls Italian operating subsidiaries.

However, the tax administration hinted that Italian-owned, foreign ''passive'' holding companies could be treated as resident in Italy for tax purposes, under the anti-inversion rules and the principal object test of the code, based on the business activities carried out in Italy by the Italian subsidiaries they control.

General Rules on Corporate Tax Residency

Italian law determines the tax residency of corporations under any one of three alternative tests: legal (statutory) seat, place of administration (effective management), and principal place of business (principal object). A corporate entity is treated as resident in Italy for tax purposes (and is subject to tax in Italy on its worldwide income) if for more than 183 days in a year it has maintained in Italy its legal seat, place of administration, or principal place of business.

The legal seat is the entity's registered office as appearing from its organizational documents filed with the Italian Register of Enterprises or equivalent foreign agency. As phrased in the statutes, the legal seat is a bright-line, formal test. However, in applying that test, Italian courts and tax administration have often referred to the entity's actual seat, as opposed to its statutory seat. Actual seat is where the effective management, direction, and administration of the entity take place. The concept of actual seat elaborated by the courts ultimately overlaps with the place of effective management test.

The place of management is where the entity's directors (as appointed in the entity's organizational documents at time of formation or by shareholders' or board's resolution thereafter) meet and conduct their business. From this perspective, the test is a formal test. However, according to the courts and tax administration, if the board does not actually exercise management and control but simply ratifies decisions taken by others, the place of management is where the shareholders or members exercise control or where outsiders who dictate the decisions of the board actually act and operate. Also, the courts and tax administration disregard nominee directors and look at those who actually run the entity to determine the entity's place of management. The place of effective management is often interpreted as the place where the strategic decisions for the entity, as opposed to the day-to-day ordinary administration, take place.

An entity's principal object or business consists of the series of specific business activities that the entity purports to carry on as defined in the entity's organizational documents (such as the certificate of formation, bylaws, partnership agreement, and shareholders' agreement), which are filed with the Italian Register of Enterprises (or equivalent foreign authority). The test is met if the main and substantial business activity of the entity as described in the entity's documents is performed in Italy. From this perspective, the test is a formal test. However, as with the legal seat and place of administration tests, the courts and tax administration take a substance-over-form approach in interpreting the principal object test. As a consequence, they look at the place where the entity's main and substantial business activities are actually carried out and operated, as opposed to where they should be located in accordance with what appears from the entity's organizational documents. Ultimately, this test overlaps with the actual seat and place of effective management test.

The burden to prove the Italian tax residency of an entity rests on the tax administration. As a result, the tax administration is responsible for collecting all of the evidence on all relevant facts and circumstances as is required to show that an entity's actual seat, place of

effective management, or place of principal business is located in Italy. If it fails to discharge that burden of proof, the entity's formal legal seat, place of board of directors' meetings, and statutory place of business as appearing from the entity's documents, if located abroad, would create a sort of presumption that would lead to the placement of the entity's corporate tax residency outside of Italy.

In the past, taxpayers have relied on the high degree of formality and manipulability of the formal corporate residency tests, and on the difficulties for the tax administration to discharge the burden of proof required to establish corporate tax residency in Italy under the facts and circumstances version of those tests, to invert the legal structure of Italian corporate groups by placing holding companies located in favorable tax jurisdictions at the top of the group. Those companies were typically treated as nonresidents because their legal seat, where their board of directors or managers meet and administer the companies, and where their business is carried out according to their statutory documents, is in the entity's home countries. Taxpayers have then been able to reduce profits subject to high tax in Italy by means of deductible payments (royalties, interest, and rents) to related nonresident holding companies (or affiliates). Those payments are often free from withholding tax under the EU directives or are subject to reduced withholding tax rates under applicable tax treaties and are subject to low or no tax in the holding company's (or affiliate's) home country.

Anti-Inversion Rules

To contrast that strategy and avoid income-stripping techniques, in 2006 the government enacted new anti-inversion rules that in some circumstances (perceived as abusive) shift the burden of proof of foreign tax residency of a foreign entity to taxpayers.

According to new paragraphs 5-*bis* and 5-*ter* of Tax Code section 73, the place of management of a foreign entity is presumed to be located in Italy (and, therefore, the entity is deemed to be resident in Italy for all tax purposes) when the entity directly controls an Italian resident company and it is directly or indirectly controlled by Italian resident persons (individuals or entities) or is managed by a board of directors or equivalent body, the majority of whose members are Italian residents. Control means, alternatively, ownership of more than 50 percent of the votes that can be exercised at the shareholders' ordinary meeting (which elects the company's directors), ownership of a sufficient number of votes (even though less than 50 percent) to exercise dominant influence at the shareholders' ordinary meetings, or ability to exercise a dominant influence at the shareholders' ordinary meeting (even in the absence of stock ownership or formal voting power) as a result of specific contractual relationships or arrangements.

For a foreign holding company controlling an Italian-resident entity, the statute refers to direct control. However, article 2359(2) of the Italian Civil Code provides for attribution of voting power held through controlled companies, fiduciary companies, and conduits. For the resident persons controlling the foreign holding company, control can also be indirect (which means pro rata of full attribution of control or voting power owned by lower tier entities in the group).

If the presumption applies, the foreign entity is automatically treated as resident in Italy for all tax purposes. The most immediate effect is that the entity will be subject to tax in Italy on its worldwide income and must fulfill all related filing and reporting obligations there. Equally, the deemed resident entity is subject to withholding tax obligations for all payments for which withholding tax is due in Italy, such as interest, rents, royalties, or dividends paid to nonresident persons not engaged in a trade or business in Italy.

To rebut the presumption, the taxpayer is asked to provide sufficient evidence that the entity's actual seat and effective management are located not in Italy but in a foreign country. For that purpose, the taxpayer must provide adequate proof of all the relevant facts and circumstances that demonstrate a real link between the management of the company and the foreign country.

Ruling 312/E

The ruling refers to a case in which a company organized in the Netherlands owns the stock of some Italian operating companies. Italian shareholders own the Dutch holding company. This is a classic structure common to many Italian groups, which have holding companies in favorable jurisdictions on top to benefit from more favorable rules on participation exemption and taxation of passive income applicable in those jurisdictions. The Dutch holding company is not engaged in any trade or business in the Netherlands. Rather, it merely holds the stock of the Italian operating subsidiaries.

The taxpayer relied on the minutes of meetings of the company's board of directors and on the company's financial statements, bank accounts, and invoices to various professionals involved in the management of the company in the Netherlands, and took the position that the company is resident in the Netherlands, where the day-to-day management takes place. According to the taxpayer, the company is not qualified as an Italian-resident company under the new anti-inversion rules because there is sufficient evidence that its day-to-day management takes place in the foreign country where it is incorporated.

The tax administration argued that the analysis on the tax residency of an Italian-owned foreign company

under the new anti-inversion rules (and general statutory rules) is highly factual and involves a careful examination of all of the facts and circumstances of each specific case, rather than involving a question of interpretation of statutory provisions. It referred to the general place of effective management test, according to which tax residency of a company is located in the place where the strategic decisions on a company's businesses activities are taken (consistently with tax treaties' tie-breaker rule on tax residency of corporations). The tax administration also referred to the principal object test, and reminded that this test applies also for treaty purposes, under a specific reservation made by Italy with reference to article 4 of the OECD model. The principal object test focuses on the place where a company's principal business is carried out and also requires a careful analysis of all the facts of the specific case.

The tax administration argued that the analysis under those tests is highly factual and does not permit a final answer on the basis of limited information provided with a ruling application, especially if it concerns a ''passive'' holding company, that is, a company that does not engage in any active business and does not perform active functions or services to the benefit of its controlled subsidiaries, but is limited to holding the stock of operating subsidiaries. In this case, according to the tax administration, the place of effective management as referred to the administration of the holding company has a rather limited meaning, and the principal object test is practically inapplicable, unless it is referred to the business of the operating subsidiaries.

The tax administration concluded that it will be unable to issue any ruling under the above circumstances and that taxpayers have the chance of proving the foreign residency of an Italian-owned foreign holding company, presumed to be resident in Italy under the anti-inversion rules, in response to any audit carried out by the tax administration.

Comments

The ruling is significant in that it raises the problem of determining the tax residency of holding companies under the general tax residency rules. It would seem to suggest that there is a distinction between ''passive'' and ''active'' holding companies for the purposes of the place of management and principal object tax residency tests.

Active holding companies are those engaged in the active management of the stock of their controlled subsidiaries, which perform active functions to the benefit of the subsidiaries, including administrative and accounting services and centralized treasury services. The place of business for active holding companies can reasonably be located in the country where they are organized and perform their active management functions, and the company's place of management is where the strategic decision on the administrative and managerial functions of the holding company take place.

In contracts, passive holding companies are those that just own the stock of other companies, without engaging in any active role or activities regarding the management of the subsidiaries' stock.

In this case, the test based on the holding company's place of effective management has no real meaning because there are no active functions performed at the level of the holding company and the only administrative activities that concern the holding company are clerical in nature (accounting, bookkeeping, and record keeping) and show no meaningful contact between the company and its own country of organization for residency purposes.

Similarly, the principal object test is practically inapplicable, in the absence of an active business performed by the holding company in its own country.

To address the issue, there may be the temptation to test the principal object at the level of the holding company's operating subsidiaries and to establish the tax residency of the holding company in Italy, if the foreign passive holding company is deemed to indirectly operate an active business in Italy through its Italian subsidiaries or indirectly own the assets located there.

Case Law

In a recent decision (judgment 108/16/07 of July 13, 2007) the Tax Court (*Commissione Tributaria Provinciale di Firenze*) ruled that the tax residency of a company based in San Marino that owned a piece of real estate in Italy had to be located in Italy, where the decisions concerning the use of the real estate took place.

Conclusion

The anti-inversion rules on corporate tax residency are putting more pressure on Italian taxpayers who use foreign companies to manage and control stock of Italian subsidiaries with active business operations or assets in Italy. Taxpayers have the burden to prove that the actual and effective management of the foreign holding company takes place in the foreign country. The mere appointment of nominee directors is not sufficient for this purpose.

The proof may be particularly difficult to provide in case of passive holding used as mere legal boxes to own stock of Italian operating companies. Taxpayers may have to engage in more planning, including the appointment and use of directors in foreign countries who sit on the board and perform real and active roles in the management of the foreign holding company. ◆

♦ *Marco Rossi, Marco Q. Rossi & Associati, Genoa and New York*