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Italy's tax administration has ruled on the interpretation of the high-tax exception in the application of Italy's controlled foreign corporation provisions, which require the current inclusion of income of certain foreign entities controlled by or related to Italian resident persons.

According to the tax administration's Resolution 63/E of March 28, the minimum level of foreign tax on the profits of a foreign enterprise controlled by or related to Italian resident persons that has the effect of excluding the application of the CFC rules must be determined on an aggregate basis by taking into account the taxes that apply on the profits when earned by the CFC and repatriated to the Italian controlling or related persons through the various levels of the group.

Therefore, if a CFC is owned through intermediate foreign entities (that are not themselves CFCs) and the combined levels of tax on the profits of the CFC when earned by the CFC, paid to the foreign direct owners of the CFC, and repatriated to the Italian ultimate owners of the CFC meet the minimum threshold required by the high-tax exception, the CFC rules do not apply.

Overview of CFC Rules

Italian Tax Code article 167 requires that the profits of a foreign enterprise resident or organized in one of the low-tax jurisdictions listed by the tax administration and controlled by or related to Italian resident persons be attributed pro rata and taxed currently in the hands of the Italian controlling or related owners.

Entities Subject to the Rules

Foreign enterprises subject to the rules include sole proprietorships, partnerships, corporations, and any other business entities. Italian owners may be resident individuals, companies, or partnerships. The CFC rules apply to controlled and related foreign enterprises. The control test is met in three situations:

- if an Italian resident person owns (directly or indirectly) more than 50 percent of the foreign enterprise's voting stock;
- if an Italian resident person owns (directly or indirectly) a sufficient amount of voting stock to exercise a dominant influence on the foreign enterprise; or
- if an Italian person can exercise a dominant influence on the foreign enterprise as a result of contractual arrangements.

Voting stock (or contractual control) owned through an agent or intermediary is attributed to the principal. Voting stock (or contractual control) owned by a controlled entity is attributed (pro rata) to the controlling entity. Therefore, control can be either direct or indirect.

Direct control exists when an entity directly owns voting power in the foreign entity that gives it control under any of the tests set forth above. Indirect control exists when an entity owns control of the foreign entity through other directly controlled entities. In other words, it directly owns controlling stock in other entities that own stock in the foreign entity that is attributed to the former entity (pro rata) and that give it control of the foreign entity under any of the control tests set forth above.

Voting stock owned by two or more persons acting in concert under special agreements (such as shareholders' pacts and similar arrangements) is aggregated to determine whether there is joint control of the foreign entity.

Control must exist at the end of the foreign enterprise's tax year. Transfers or changes in the percentage of voting stock carried out near year-end to avoid control are subject to the antiavoidance provisions of article 37-*bis* of Presidential Decree 600 of September 29, 1973.

Foreign related entities are entities of which an Italian person directly or indirectly owns at least 20 percent of the stock by profit share. The threshold is reduced to 10 percent for publicly traded foreign entities.

Residency or Place of Organization

To be a CFC, the foreign entity must be resident or based in a blacklisted country. Residency is determined under foreign law. An entity is based in a low-tax jurisdiction when it does business there and its income is taxable in that jurisdiction. Consequently, the profits of a permanent establishment located in a blacklisted jurisdiction owned by an enterprise that is resident in a nonblacklisted country are subject to the CFC rules if the resident country exempts those profits from tax and the profits are subject to low or zero taxation in the country of the PE.

The blacklist, approved in a ministerial decree dated November 21, 2001, includes two European Union member states, Cyprus and Malta.

The Italian tax administration has taken the position that the Italian CFC rules are EU-proof — that is, that they apply only to wholly artificial arrangements according to the test elaborated by the European Court of Justice in *Cadbury Schweppes* under the active trade or business and high-tax exceptions (described in more detail below). (For the ECJ judgment in *Cadbury Schweppes* (C-196/04), see *2006 WTD 177-8* or *Doc 2006-19082*.)

Computation of CFC's Taxable Income

A CFC's income is recomputed under Italian tax rules. Some favorable tax provisions — such as those permitting accelerated depreciation and delayed taxation of gains (from the sale of fixed assets held for more than three years) by way of equal installments over a period of five years — do not apply.

The taxable income of a related CFC is the higher of the income resulting from the CFC's financial statement (adjusted in accordance with Italian tax rules) or a conventional amount determined as a percentage of the value of the CFC's assets equal to 1 percent of stock, obligations, and other financial investments; 4 percent of immovable assets; and 15 percent of all other fixed assets.

Attribution of CFC's Income to Italian Owners

The taxable income of the CFC (computed as above) is attributed to the CFC's Italian controlling or related owners in proportion to their share of the profit of the CFC on the last day of the CFC's tax year.

In case of indirect control held through other (controlled) resident entities, the CFC's income is attributed to the direct shareholders — namely, the controlled resident entities that directly own the stock in the CFC — rather than the ultimate controlling parent.

The CFC's pro rata share of income is taxed at the higher of the average effective tax rate of the Italian person that includes the income or a flat rate of 27 percent. The included share of the CFC's taxable income is taxed on a separate basis and cannot be offset with unrelated losses.

Dividends, Credits, and Basis

Dividends paid out of a CFC's previously taxed income are excluded from tax. An indirect credit is granted for the underlying taxes paid by the CFC on its included income.

The adjusted tax basis in CFC stock is increased by an amount equal to the CFC's income inclusion and decreased by the amount of distributions received out of the CFC's previously taxed income and the pro rata share of the CFC's taxable losses.

High-Tax Exceptions

The application of the CFC rules is excluded in either of two situations: if the CFC carries out an active trade or business in its country of residence or organization, or if holding stock in the CFC does not have the effect of shifting income to a low-tax jurisdiction.

The active trade or business exception requires that the CFC use an adequate organization (offices, staff, assets) to carry out its business in its home jurisdiction. Passive assets-holding activities do not satisfy the test.

The high-tax exception requires that the CFC's income be subject to an adequate level of foreign tax. Regulations provide that at least 75 percent of a CFC's income must be earned in a nonblacklisted country where income is subject to local ordinary taxes.

The application of either exclusion requires a preliminary ruling from the tax administration.

Ruling 63/E discusses the interpretation and application of the high-tax exception in the case of indirect ownership of a CFC through an intermediate non-CFC.

Facts of the Ruling

An Italian company acquired a U.S. company that owns various operating subsidiaries through a wholly owned Cypriot holding company. Since 2006 the Cypriot company has been subject to the ordinary 10 percent corporate income tax in Cyprus (it previously benefited from a special tax regime for offshore companies and paid taxes at the reduced rate of 4.25 percent).

Under Italian tax law, the Cypriot holding company is a CFC and the Italian company is its ultimate controlling shareholder. Consequently, the Cypriot holding company's income (dividends and other payments received from its operating subsidiaries) is taxed currently in Italy in the hands of the Italian parent company at the combined corporate and IRAP (regional tax on productive activities) tax rate of 37.5 percent on a separate basis and without offset for the Italian parent's losses. An indirect credit is granted for the underlying taxes paid in Cyprus.

The taxpayer argued that the ownership of the Cypriot company does not have the effect of locating profits in a low-tax jurisdiction and that the CFC rules should therefore not apply, because when the Cypriot company distributes its profits as dividends to its U.S. parent, the profits are subject to a 35 percent corporate income tax in the United States (with an indirect credit for the underlying foreign taxes paid on the distributed profits). Then, when the U.S. parent distributes the profits to the Italian ultimate owner, the profits are subject to additional U.S. withholding tax (presumably, at the reduced 5 percent treaty withholding tax rate).

Therefore, the taxpayer said, if the Cypriot company annually distributed its profits to its U.S. parent, the profits of the CFC would be subject to a level of foreign taxes that would be comparable to the level of Italian tax, and the application of the CFC rules should be excluded under the high-tax exclusion rule.

The current distribution of the profits of the CFC ensures that — taking into account the taxes paid in Cyprus when the profits are earned and those paid in the United States when the profits are distributed — the foreign taxes on the CFC's profits are not less than at least 70 percent of the Italian tax. That should be enough to trigger the exclusion, the taxpayer argued.

Tax Administration's Analysis

The tax administration agreed with the taxpayer.

It observed that the active trade or business exception does not apply because the Cypriot company is a holding company. (Holding and managing stock in other entities does not amount to an active trade or business for the purpose of excluding the application of CFC rules.)

It then discussed the high-tax exception and the special test set forth in the regulations, which state that the exception applies when at least 75 percent of the CFC's income is produced in a nonblacklisted country and is subject to ordinary tax there. In that regard, the tax administration observed that all income of the Cypriot company is produced in Cyprus (where the CFC is located); therefore, the special test is not met.

The tax administration interpreted the term "produced" in a nontechnical sense as being synonymous with "received" and located the income received by the CFC in the CFC's home jurisdiction, regardless of the sources from which the CFC derived it.

In other words, the tax administration did not elaborate on the actual source of the income earned by the Cypriot company, according to the general income source rules, nor did it investigate further how that income may have been taxed in the country of source (from which it was earned by the CFC), either on a net basis (in case of active business income) or through withholding tax (in the case of passive income).

However, the tax administration also observed that the test is not exclusive and should be interpreted broadly. In particular, consistent with the general ratio of the high-tax exclusion, the CFC rules do not apply in situations in which the aggregate level of foreign taxes on the profits of the CFC, determined on a group basis (that is, considering the taxes that apply on the profits at each level of the group chain, while the profits are repatriated to the ultimate Italian parent), is sufficiently similar to the level of the Italian tax that would apply under the CFC rules and when the use of the CFC is not designed to achieve deferral of Italian tax.

Therefore, in the case at issue, the CFC rules will not apply if the taxpayer provides, year by year, adequate evidence that a sufficient amount of profits have been distributed as dividends by the CFC to the U.S. parent and have been taxed in the hands of the U.S. parent in the United States so that the foreign tax paid each year is at least equal to 27 percent of the total income of the CFC (the minimum tax that would apply under the Italian CFC rules).

The tax administration clarified that the taxpayer will have to submit clear documentary evidence concerning the nature, computation, and amount of the CFC's income, the distribution of the income to the U.S. company, and the actual amount of foreign tax to which the income has been subject in the relevant year. In the absence of such evidence, the income will be taxable in the hands of the Italian parent.

Comments

The ruling is useful in that it clarifies the general ratio and scope of the high-tax exception and confirms that the exception applies to all cases in which the profits of a CFC have been subject to at least one level of tax in a foreign country that is not a CFC jurisdiction.

The ruling applies that rationale by looking at how the profits of a CFC are taxed when distributed as dividends to a non-CFC shareholder. If they are distributed currently and subject to ordinary tax in the hands of the non-CFC shareholder, the CFC rules do not apply.

More generally, the ruling confirms the position that if the profits of the CFC are subject to at least one level of foreign tax in the group to which the CFC belongs, considered on an aggregate basis, the CFC rules do not apply.

Proving the actual amount of effective foreign tax paid on the CFC's income on an aggregate basis within the group before that income reaches the Italian controlling owner, and assessing it against the theoretical Italian tax that would apply under Italy's CFC rules, is not an easy task.

It requires computation of the CFC's income and foreign taxes under the laws of all foreign countries involved and then the recomputation of income and taxes under Italian law to make the comparison between foreign and Italian effective tax rates on that income. That in turn presupposes a clear understanding of foreign tax laws, including foreign rules on the determination of taxable basis (the timing of inclusions, deductions, and so on), which is difficult to achieve and requires extensive resources, both on the part of taxpayers and the tax administration. It is difficult to predict how that analysis can be conducted in practice.

However, the tax administration (and the taxpayer) appears to have missed an opportunity in considering the 75 percent test. The test asks whether at least 75 percent of the income is produced in a nonblacklisted country and has been subject to ordinary tax there.

In the case of passive income received by a CFC from related foreign entities established in nonblacklisted jurisdictions, income is sourced in the country of the payer, according to the general income source rules. A look-through approach should apply so that if the income received by the CFC (in the form of dividends, interest, or royalties) is properly allocable to income of the related paying entity that is not a CFC (and was subject to ordinary tax when earned in the country where the entity is located and carries out its business), the CFC rules should not apply. The rate or amount of foreign tax should be irrelevant for that purpose.

The look-through approach would make the 75 percent test operate in a way that is similar to the look-through rules of U.S. Internal Revenue Code section 954(c)(6). It also would seem to be consistent with the proposition that the high-tax exclusion is generally applicable and operates when there has been at least one level of foreign tax on the CFC's income.

By the same token, any gross-basis withholding tax charged on income paid to the CFC should also count for purposes of the high-tax exception. Indeed, the "one level of foreign tax" rationale (to be assessed on a group basis), which is used in the ruling, should also work for taxes paid by the lower-level entity (owned by the CFC) on the profits when earned, as well as for taxes paid by the upper-level entity (owing the CFC) when the same profits are distributed up as dividends (to the CFC). ◆

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