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Tax Treaties, Hybrid Entities and Tax Planning

(Italy-U.S. Perspective)

Marco Q. Rossi
Marco Q. Rossi & Associati
Italy - New York
300 Park Avenue, New York, NY 10022
T. 212 572 6279 - F. 212-572 6499
mrossi@lawrossi.com

I. Entity Classification

A. Domestic vs. Foreign Entities

- Domestic entities are entities organized under Italian law.
- Foreign entities are entities organized under foreign law.

B. Resident vs. Nonresident Entities

- Resident entities (foreign or domestic) are entities with registered office, place of management or principal place of business in Italy for most part of the taxable year (i.e., >183 days).
- Nonresident entities (foreign or domestic) are all entities that are not resident.

C. Taxable vs. Non-Taxable Entities

1. Taxable Entities:

- resident joint stock companies (*Società per Azioni* - SPAs);
- resident limited partnerships with capital divided by shares (*Società in Accomandita per Azioni* - SAPAs);
- resident limited liability companies (*Società a Responsabilità Limitata* - SRLs);
- resident cooperative companies;
- resident mutual insurance companies;
- other resident state or private business and nonbusiness organizations;
- nonresident entities of any type, regardless of their legal characteristics, tax classification and treatment under foreign law.

2. Non-Taxable Entities:

- resident general partnerships (*Società in Nome Collettivo* - SNCs),
- resident limited partnerships (*Società in Accomandita Semplice* - SASs),
- resident non-registered (irregular) partnerships (*Società di Fatto*- SFs).

Note: nonresident entities (foreign or domestic) of any type are treated as separate entities regardless of their legal characteristics, classification and tax treatment under foreign tax laws.

Highlights:

Domestic resident entities organized in a legal form that provides for limited liability, centralized management and unlimited life (typically, joint stock company - SPA - limited liability company - SRL - and limited partnership with stock divided by shares - SAPA) are classified as separate entities and are subject to corporate income tax (i.e., they are corporations in the U.S. tax sense).

Domestic resident entities organized in a legal form that provides for unlimited liability, non-centralized management and limited life (e.g., general partnership - SNC - limited partnership - SAS -) are treated as fiscally transparent entities not subject to tax (i.e., they are partnerships in the U.S. tax sense).

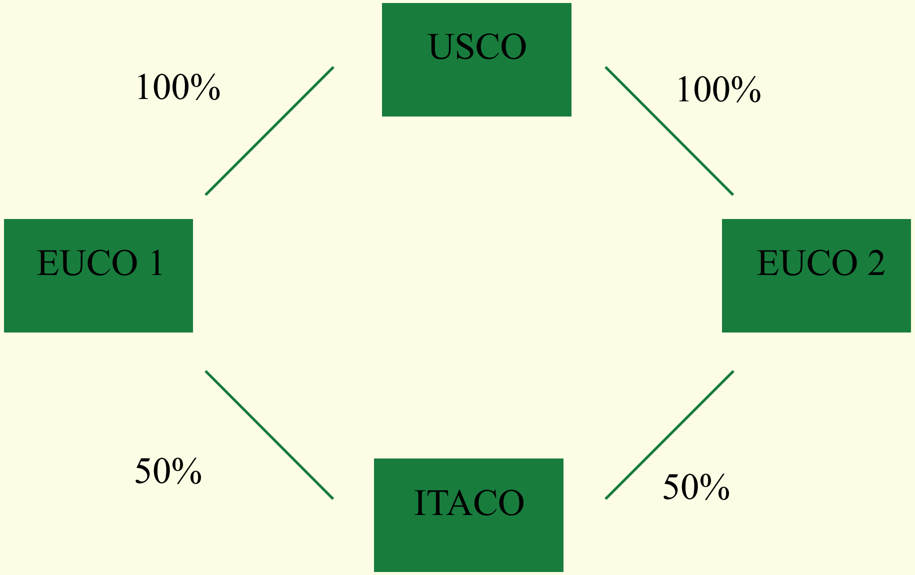
Nonresident entities are treated as separate entities (i.e., like corporations in the U.S. tax sense) in any event, regardless of their legal form, characteristic and tax treatment under foreign law.

Resident corporations are taxed on their worldwide income. Nonresident entities are subject to tax in Italy only on their Italian source income.

II. Italy's "Check-the-Box" Rules

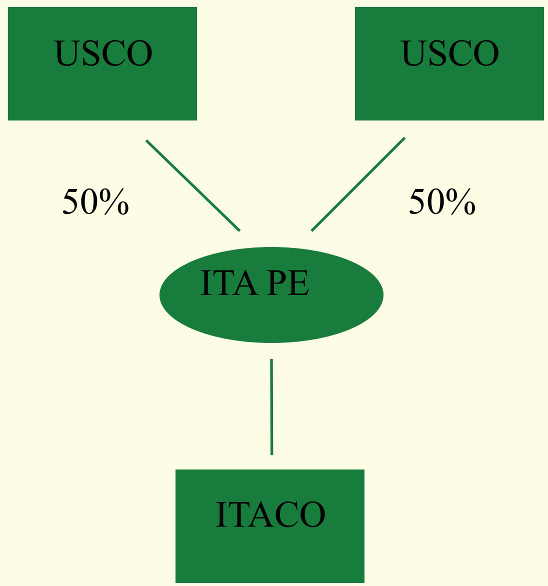
- Domestic resident companies (SPAs, SRLs, SAPAs) can elect to be treated as fiscally transparent entities.
- Requirements:
  - each owner must own (directly) no less than <u>10</u> percent and no more than <u>50</u> percent of stock (measured by voting power and profits share);
  - owners can only be (domestic) <u>resident</u> <u>companies</u>;
  - owners can also be <u>nonresident</u> entities if no withholding tax on dividends would apply (i.e., they are EU parent companies exempt from withholding tax under the EC Parent-Subsidiary Directive or own the stock through a PE in Italy).

Stock of Italian company held in a diamond structure through EU holding companies:



The Italian company can elect to be treated as fiscally transparent under Italy's "check-the-box" rules.

Stock of Italian company owned through a PE in Italy



The Italian company can elect to be treated as fiscally transparent under Italy's "check-the-box" rules

III. Fiscal Transparency under Italian Law

- entity's income and loss flows through to the owners;
- entity's income is computed in the same way as income of individuals;
- income of companies that "checked the box" is computed in the same way as income of companies;
- the character of income does not flow through (distributive share of entity's income is "income realized in associated form" and is characterized as business income);
- the source of income does not flow through (distributive share of entity's income is Italian source income);
- payments to an Italian fiscally transparent entity are not subject to withholding by the Italian payor (same result as under IRC §§ 1441-1442);
- Italian fiscally transparent entities are not obligated to withhold on distributions to foreign owners or on foreign owners' distributive shares of entity's income (different results under IRC §§ 1441-1442);
- foreign owners must file an income tax return in Italy reporting their distributive share of Italian entity's income and are subject to net-base income tax in Italy.

IV. Tax Treaties

- U.S-Italy 1984 Treaty (in force) contains art. 4(1)(b) which is based on 1981 U.S. Model Treaty;

- art. 4(1)(b) of U.S.-Italy 1999 Treaty (pending) is unchanged;

- Italy does not have statutory or regulatory provisions on the matter of application of tax treaties to partnerships or hybrid entities;

- Italian courts and tax administration would most likely rely on OECD materials (Commentary, Report), U.S. Treaty Model and Treasury Department Technical Explanation to current/pending U.S.-Italy tax treaties.

A. U.S.-Italy 1984 Tax Treaty (in force)

Article 4(1)(b)

Resident

"In the case of income derived or paid by a partnership ... this term applies only to the extent that the income derived by such partnership ... is subject to tax in that State, either in its hands or in the hands of its partners or beneficiaries"

Treasury Department Technical Explanation

Article 3 - General Definitions -

"A partnership is understood to be included with the reference to 'any other body of persons'".

Article 4 - Resident -

"A partnership ... will be considered a resident of a Contracting State only to the extent that the income it derives is subject to tax by that State, either at the entity level or in the hands of the partners ... as the income of a resident. For example, a U.S. partnerships which derives income from Italy and which is comprised of two partners who are resident of the United States and two partners who are resident of a third country will be considered a U.S. resident only to the extent of the shares of such income attributable to the partners who are U.S. residents. Treaty benefits, such as reduced withholding rates on dividends and interest, need not be extended by Italy to the portion of the income derived by the U.S. partnership which is passed through to the nonresident partners".

B. U.S.-Italy 1999 Tax Treaty (pending)

Article 3(1)(a)
General definitions
"the term 'person' includes a partnership"

Article 4(1)(d)
Resident
"In the case of income derived or paid by a partnership ... this term applies only to the extent that the income derived by such partnership ... is subject to tax in that State, either in its hands or in the hands of its partners or beneficiaries"
(not modified)

Treasury Department Technical Explanation

Article 4 (Resident)

"Fiscally transparent entities such as partnerships ... present special issues. Subparagraph b) of of paragraph 1 of Article 4 addressed income derived or paid by a partnership ... Subparagraph 5(c) of the Protocol clarifies that the provisions of subparagraph 1(b) of Article 4 apply to determine the residence of an entity that is treated as fiscally transparent under the laws of either Contracting State. *Thus, although the language of subparagraph (b) of paragraph 1 of Article 4, as clarified by the Protocol, differs from the language of subparagraph 1(d) of Article 4 of the U.S. Model, the results are intended to be the same*".

"In general, subparagraph (b) of paragraph 1 of Article 4, as clarified by the Protocol, relates to entities that are not subject to tax at the entity level, as distinct from entities that are subject to tax, but with respect to which tax may be relieved under an integrated system. This subparagraph applies to any resident of a Contracting State who is entitled to income derived through and entity that is treated as fiscally transparent under the Laws of either Contracting State. Entities falling under this description in the United States would include partnerships, common investment trusts under section 584 and grantor trusts. This subparagraph also applies to U.S. limited liability companies ("LLCs") that are treated as partnerships for U.S. tax purposes".

"This subparagraph provides that an item of income derived by such a fiscally transparent entity will be considered to be derived by a resident of a Contracting State if the resident is treated under the taxation laws of that State where he is resident as deriving the item of income. For example, if a corporation resident in Italy distributes a dividend to an entity that is treated as fiscally transparent for U.S. tax purposes, the dividend will -

be considered derived by a resident of the United States only to the extent that the taxation laws of the United States treat one or more U.S. residents (whose status as U.S. residents is determined, for this purpose, under U.S. tax laws) as deriving the dividend income for U.S. tax purposes. In the case of a partnership, the persons who are, under U.S. tax laws, treated as partners of the entity would normally be the persons whom the U.S. tax laws would treat as deriving the dividend income through the partnership. Thus, it also follows that persons whom the U.S. treats as partners but who are not U.S. residents for U.S. tax purposes may not claim a benefit for the dividend paid to the entity under the Convention. Although these partners are treated as deriving the income for U.S. tax purposes, they are not residents of the United States for purposes of the treaty. If, however, they are treated as residents of a third country under the provisions of an income tax convention which that country has with Italy, they may be entitled to claim a benefit under that Convention. In contrast, if an entity is organized under U.S. laws and is classified as a corporation for U.S. tax purposes, dividends paid by a corporation resident in Italy to the U.S. entity will be considered derived by a resident of the United States since the U.S. corporation is treated under U.S. taxation laws as resident of the United States and as deriving the income".

"These results would obtain even if the entity were viewed differently under the tax laws of Italy (e.g., as non fiscally transparent in the first example above where the entity is treated as a partnership for U.S. tax purposes or as fiscally transparent in the second example where the entity is viewed as not fiscally transparent for U.S. tax purposes). These results also follow regardless of where the entity is organized, i.. in the United States, Italy or a third country. For example, income from sources in Italy received by an entity organized under the laws of Italy, which is treated for U.S. tax purposes as a corporation and is owned by a U.S. shareholder who is a U.S. resident for U.S. tax purposes, is not considered derived by the shareholder of that corporation even if, -

under the laws of Italy, the entity is treated as fiscally transparent. Rather, for purposes of the Treaty, the income is treated as derived by an entity resident in Italy. These results also follows regardless of whether the entity is disregarded as a separate entity under the laws of one jurisdiction but not the other, such as a single owner entity that is viewed as a branch for U.S. tax purposes and as a corporation for tax purposes of Italy".

Article 3 (General Definitions)

"Although subparagraph 1(c) does not include the U.S. Model's explicit reference to fiscally transparent enterprises, the negotiators understood that the terms 'enterprise of a Contracting State' and 'enterprise of the other Contracting State' encompass an enterprise conducted through an entity (such as a partnership) that is treated as fiscally transparent in the Contracting State where the entity's owner is resident. In accordance with Article 4 (Resident), entities that are fiscally transparent in the country in which their owners are resident are not considered to be residents of a Contracting State (although income derived by such entities may be taxed as the income of a resident, if taxed in the hands of resident partners or other owners). This treatment ensures that an enterprise conducted by such an entity will be treated as carried on by a resident of a Contracting State to the extent its partners or other owners are residents. This approach is consistent with the Code, which under section 875 attributes a trade or business conducted by a partnership to its partners and a trade or business conducted by an estate or trust to its beneficiaries".

C. U.S. Model Treaty 1996

Article 3(1)(a)

General definitions

"the term 'person' includes ... a partnership ..."

Article 4(1)(d)

Resident

"An item of income, profit or gain derived through an entity that is fiscally transparent under the laws of either Contracting State shall be considered to be derived by a resident of a State to the extent that the item is treated for purposes of the taxation law of such Contracting State as the income, profit or gain of a resident".

Treasury Department Technical Explanation

“Subparagraph (d) addresses special problems presented by fiscally transparent entities such as partnerships and certain estates and trusts that are not subject to tax at the entity level. This subparagraph applies to any resident of a Contracting State who is entitled to income derived through an entity that is treated as fiscally transparent under the laws of either Contracting State. Entities falling under this description in the United States would include partnerships, common investment trusts under section 584 and grantor trusts. This paragraph also applies to U.S. limited liability companies ("LLC's") that are treated as partnerships for U.S. tax purposes”.

“Subparagraph (d) provides that an item of income derived through such fiscally transparent entities will be considered to be derived by a resident of a Contracting State if the resident is treated under the taxation laws of the State where he is resident as deriving the item of income. For example, if a U.S. corporation distributes a dividend to an entity that is treated as fiscally transparent in the other State, the dividend will be considered to be derived by a resident of that State to the extent that the taxation law of that State treats residents of that State as deriving the income for tax purposes. In the case of a partnership, this normally would include the partners of the entity that are residents of that other Contracting State”.

“Where income is derived through an entity organized in a third state that has owners resident in one of the Contracting States, the characterization of the entity in that third state is irrelevant for purposes of determining whether the resident is entitled to treaty benefits with respect to income derived by the entity”.

D. OECD COMMENTARY

- General Principles: article 1, paragraphs 5 and 6 (6.1-6.7);
- Residency: article 4, paragraph 8.4 (“liable to tax” principle);
- Portfolio Income: article 1, paragraph 6.4. (“paid to” and “realized by” principles);
- Portfolio Income: article 10, paragraph 12 (“beneficial owner” principle);
- Business Profits (permanent establishment): article 5, paragraph 19.1;
- Dependent Services Income: article 15, paragraphs 6.1-6.2;
- Business Profits (and double taxation reliefs): article 23, paragraphs 32.4 and 32.7.

E. OECD PARTNERSHIP REPORT

BILATERAL CASES:

- payment to a foreign reverse hybrid (from the perspective of the source state): example 4 (treaty benefits go to the owners, if treated as fiscally nontransparent in their own jurisdiction);
- payment to a foreign regular hybrid (from the perspective of the source state): example 5 (treaty benefits go to the entity);
- payment to a domestic regular hybrid (from the perspective of the source state): example 6 (no treaty benefits apply);
- payment to a domestic reverse hybrid (from the perspective of the source state): example 17 (no treaty benefits apply).

TRILATERAL CASES:

- double denial of treaty benefits (the entity is treated as fiscally transparent in its own jurisdiction and as a separate entity in the entity's owners' jurisdiction): example 7;

- double application of treaty benefits (the entity is treated as a separate entity in its own jurisdiction and as fiscally transparent in the entity's owners' jurisdiction, which treats the entity's owners as separate entities): example 9.

PAYMENTS BY A DOMESTIC REVERSE HYBRID:

- Treaty benefits apply? See Examples 18 and 13 (and also art. 3.2 of OECD Model Treaty).

- Treaty benefits do not apply: article 1, paragraphs 7.1., 9, 9.4 (anti-abuse rule).

FIXED BASE - PERMANENT ESTABLISHMENT:

- partnership's fixed base-permanent establishment is attributed to the partner (example 12);
- partners' activities are attributed to the partnership (example 11).

(The two examples do not deal with hybrid situations).

F. U.S. DOMESTIC TAX LAW

- IRC § 894(c);
- IRC Reg. § 894-1(d);
- general rules: IRC Reg. § 894-1(d)(1);
- payments to a DRH: IRC Reg. § 894-1(d)(2)(i);
- payments by a DRH: IRC Reg. § 894-1(d)(2)(ii);

- attribution of partnership's PE to its partners: *Unger*; *Donroy*; R.R. 90-80;

- partnership's PE arising from activities of a partner: *Balanovski*

(the above mentioned case-law does not address hybrid situations).

U.S. LLCs - Example 1

U.S. Sub pays a dividend to U.S. LLC owned by a foreign entity (resident in Italy).

Situation 1: U.S. LLC has checked the box and is treated as a corporation for U.S. tax purposes. The U.S. is free to tax the payment with no restrictions. No treaty benefits apply. This is true even if U.S. LLC is treated as fiscally transparent in the owner's home country, F (i.e., it is a "domestic reverse hybrid". See OECD Report, example 17; article 1(4) of U.S. Model Tax Treaty - savings clause -; IRC Reg. §894-1(d)(2)(i)).

Situation 2: U.S. LLC is treated as a partnership (i.e., fiscally transparent) for U.S. tax purposes. U.S. LLC is treated as nontransparent in Italy. No treaty benefits apply because U.S. LLC's owner is not subject to tax in its home country upon its share of U.S. LLC's income (OECD Report, example 6; OECD Commentary, article 1, par. 6.2 and 6.3). If U.S. LLC were treated as fiscally transparent in Italy treaty benefits would apply, provided that U.S. LLC's owner is treated as fiscally nontransparent and subject to tax on its share of U.S. LLC's income in Italy or, if treated as fiscally transparent, its own owners are treated as fiscally nontransparent and subject to tax on their distributive share of U.S. LLC owner's distributive share of U.S. LLC's income (OECD Commentary article 1, par. 6.4.).

U.S. LLCs - Example 2

Italian company (F Sub) pays a dividend to U.S. LLC owned by a U.S. corporation (US Parent).

Situation 1: U.S. LLC has checked the box and is treated as a corporation for U.S. tax purposes. Italy treats U.S. LLC as fiscally nontransparent. Treaty benefits apply and Italian withholding tax is reduced or eliminated under the US-Italy tax treaty. That would be true even if Italy treated U.S. LLC as fiscally transparent for Italian tax purposes (i.e. U.S. LLC were a "foreign regular hybrid" from Italy's perspective. See OECD Report, example 5). If the payment is a dividend Italy would reduce its withholding tax to 15-10-5 percent based on U.S. LLC's direct ownership of stock of Italian corp. (see article 10(2) of U.S.-Italy tax treaty).

Situation 2: U.S. LLC is treated as a partnership (i.e., fiscally transparent) for U.S. tax purposes. U.S. LLC's owner is treated as a corporation for U.S. tax purposes. Treaty benefits do not apply to U.S. LLC. However, they apply to U.S. Parent's distributive share of U.S. LLC's income. This is true even if Italy treats U.S. LLC (or U.S. Parent) as fiscally nontransparent (see OECD Commentary, article 1, par. 6.3 and article 4, par. 8.4. and OECD Report, example 4). If payment is a dividend, what is the withholding tax rate (15-10-5)? Direct vs. indirect ownership.

Reverse Hybrids - Example 1

U.S. corporation makes an interest payment to U.K. partnership owned by Italian Sub and Italian Parent. U.K. partnership is treated as a corporation for U.S. tax purposes.

Situation 1: U.K. partnership is treated as a separate entity for Italian tax purposes. Neither U.S.-UK nor U.S.-Italy treaty benefits apply. U.K. partnership is not subject to tax in the U.K., therefore it does not qualify as a resident of the U.K. for purposes of U.S.-U.K. treaty (U.S. classification is irrelevant). The Italian owners are not subject to tax in Italy on their distributive shares of U.K. partnership's income; Italian Sub and Italian Parent are not entitled to U.S.-Italy treaty benefits (see OECD Commentary, article 1, par. 6.5, second part and OECD Report, example 7).

Variation: U.K. partnership is treated as fiscally nontransparent in the U.K. and fiscally transparent in Italy and Italian Sub/Italian Parent are fiscally nontransparent in Italy. Both U.S.-U.K. and U.S. Italy treaty apply. The U.S. should apply the lowest tax rates between those of the two treaties (see OECD Commentary, article 1, par. 6.5, first part and OECD Report, example 9).

Reverse Hybrids - Example 2

Italian Sub makes an interest payment to an Italian fiscally transparent entity owned by U.S. Sub and U.S. Parent. The Italian fiscally transparent entity is treated as a corporation for U.S. tax purposes (i.e., it is a domestic regular hybrid from Italy's perspective).

Interest payment is not eligible for treaty benefits under U.S.-Italy Tax Treaty (OECD Report, example 6, OECD Commentary, article 1, par. 6.2).

Reverse Hybrids - Example 3

Italian SPA pays a dividend to Italian SRL that pays it to US Sub. Italian SRL is owned by U.S. Sub/U.S., is a separate entity in Italy and fiscally transparent (i.e. a partnership) in the U.S.

Italy is free to tax the income of Italian SRL with no restrictions (saving clause). U.S. classification of Italian partnership is irrelevant (see OECD Report, example 17 and article 1(4) of U.S.-Italy treaty).

Variation 1: Italian SRL elects to be treated as fiscally transparent in Italy. In this case U.S.-Italy tax treaty would apply. Results: payment is taxable in Italy subject to U.S.-Italy treaty's limitations. Italian internal law treatment: no withholding tax by the Italian payor. No withholding tax by Italian entity. U.S. owner shall file an income tax return in Italy reporting its share of Italian entity's income. U.S. owner is subject to net-basis income tax in Italy. Which article of U.S.-Italy treaty does apply (11 - dividend - or 7 - business profits)?

Reverse Hybrids - Example 4

US Sub pays a dividend to US LLC which pay interest to Italy Sub. US LLC is treated as a corporation in the US.

Italy classifies US LLC as fiscally nontransparent. Therefore, interest is taxable in Italy to Italy Sub (no "double dip" - interest offsets only US income, not Italian income).

Interest is deductible in the US and not re-characterized as dividend (IRC Reg. § 1.894 -1(d)(2)(ii) does not apply; US LLC is not a DRH - it is a corporation both for US and Italy's tax purposes).

If US LLC fiscally transparent in Italy and Italy Sub owns >80% of US LLC, IRC Reg. § 1.894-1(d)(2)(ii) would apply (interest re-characterized as dividend to the extent of dividend paid by US Sub to US LLL, deemed dividend non deductible in the US and subject to US withholding tax reduced under US-Italy treaty. Do the regulations violate the nondiscrimination provision of Treaty Art. 24.3?).

Reverse Hybrids - Example 5

Italy Sub pays a dividend to Italy SRL which pays interest to US Sub. Italy SRL is a separate entity in Italy and fiscally transparent in the US.

Dividend from Italy Sub to Italy SRL is taxable in Italy without treaty restrictions (95% exempt under participation exemption rules, effective tax 1.65%). Interest paid by Italy SRL is deductible in Italy and subject to withholding tax at the reduced interest treaty rate.

No rules equivalent to IRC § 894-1(d)(2)(ii).

Ownership Through Hybrid Entities - Example 1

U.S. Sub makes a direct dividend payment to Italy 1 which owns > 10% of the stock of U.S. Sub, and a dividend payment to a partnership organized in country X, which is owned equally by Italy 1 and Italy 2 and owns 25% of stock of U.S. Sub. Italy classifies country X partnership as a separate entity.

U.S.-Italy tax treaty applies to the dividend paid to Italy 1. Withholding tax rate is 10% (indirect stock ownership in U.S. Sub does not count. On the facts of the example this is irrelevant because Italy 1 direct and indirect ownership of US Sub is still <50%).

U.S.-Italy tax treaty does not apply to the indirect dividend to Italy 1 and Italy 2. U.S.-Country X tax treaty also does not apply (OECD Report, example 7 and OECD Commentary, article 1, par. 6.5, second part).

Ownership Through Hybrid Entities - Example 2

U.S. Sub makes a dividend payment to a 100% parent organized in country X that is 100% owned by an Italian company. The country X parent is treated as fiscally transparent in country X and as a separate entity in Italy.

Neither U.S.-Italy nor U.S.-Country X treaty applies (OECD Report, example 7 and OECD Commentary, article 1, par. 6.5 second part).

If the the entity is fiscally nontransparent in country X, U.S.-Country X treaty would apply.

Ownership Through Hybrid Entities - Example 3

Italian Sub makes a dividend payment to a 100% parent organized in country X that is 100% owned by an U.S. company. Country X parent is treated as fiscally transparent in country X and the U.S. and as a separate entity in Italy.

U.S.-Italy treaty applies.

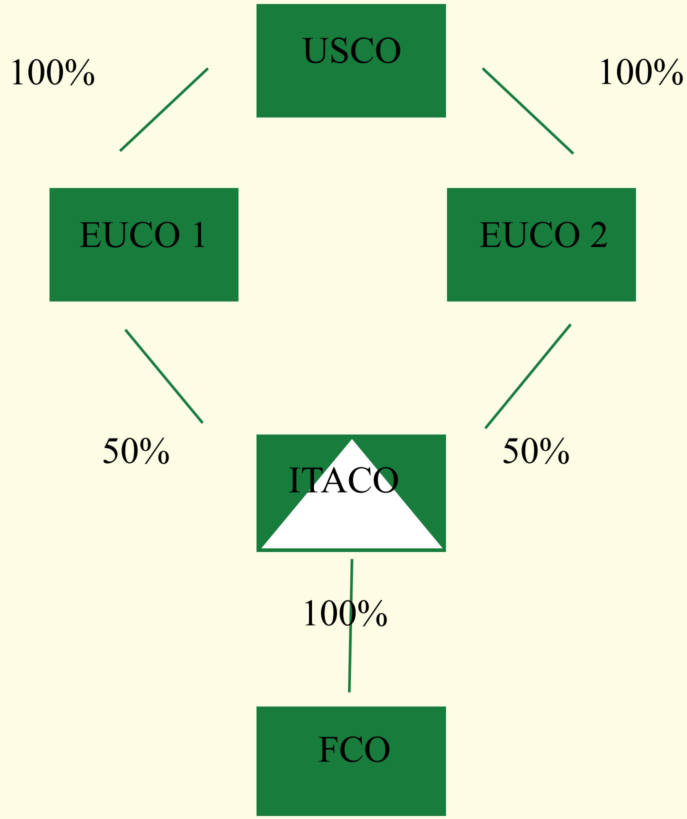
Italy's classification of country X entity is not relevant.

What treaty rate (15-10-5)? 15%.

If the hybrid is a corporation for U.S. tax purposes the U.S.-Italy treaty does not apply.

HYBRIDS - EU DIRECTIVES - TAX TREATIES

Case 1: Dividends - Fiscally Transparent Entity



Analysis - Issues:

ITACo is a fiscally transparent entity for Italian tax purposes ("checked-the-box" SpA)

FCo distributes a dividend to ITACo

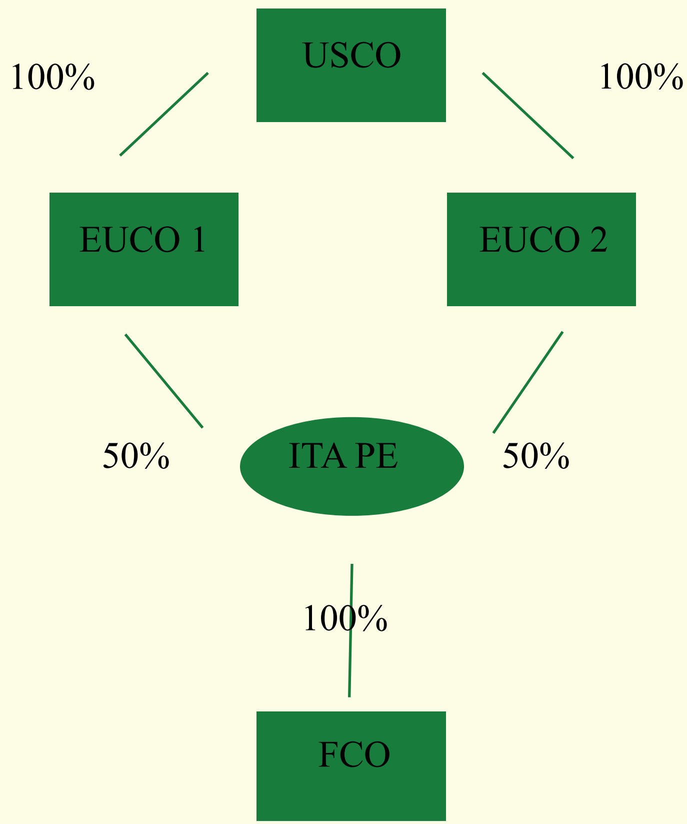
<u>Does the EU Parent-Subsidiary Directive applies to ITACo</u>? (No, because ITACo is not subject to corporate income tax in Italy. Classification of ITACo in F is not relevant).

<u>Does the EU Parent-Subsidiary Directive apply to EUCO1-EUCO2</u>? (No, because no direct ownership in FCO). What if ITACo is classified as a fiscally transparent in EU? Should this make any difference?

<u>Does F-EU Tax Treaty applies</u>? (No. Answer would be yes if EU treated ITACo as fiscally transparent and EUCo1 and EUCO2 are non fiscally transparent in EU).

<u>Does F-U.S. Tax Treaty applies</u>? (yes, if U.S. treats EUCO1-EUCO 2 and ITACo as fiscally transparent and USCO is not-fiscally transparent in the US).

Case 2: Dividends - PE



Analysis - Issues:

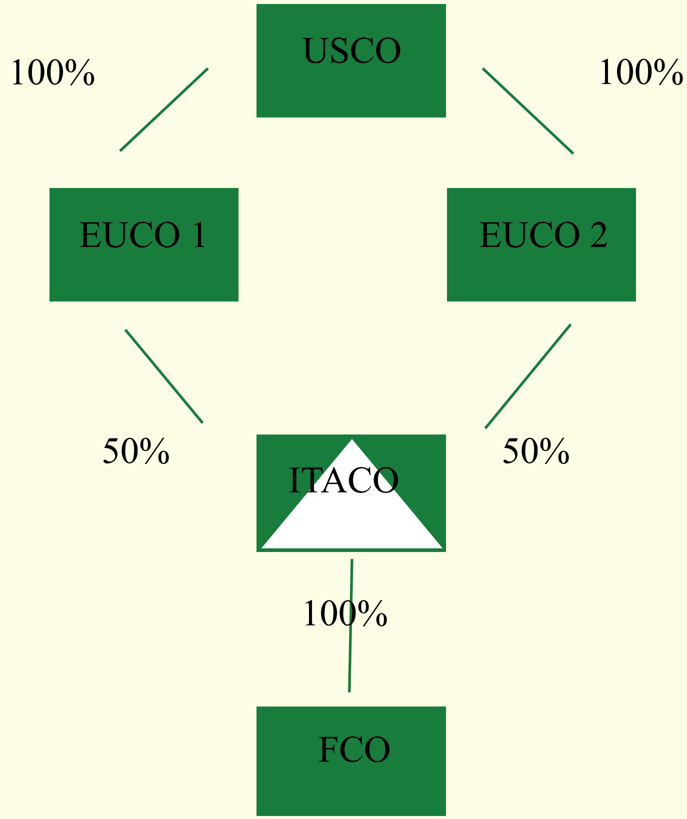
FCo distributes a dividend to EUCo 1 and EUCo 2 (or their PE in Italy).

Does the EU Parent-Subsidiary Directive apply to EUCo1-EUCo2? Yes (Art. 3(1)(a) second sentence). Result: no French withholding tax.

If F stock is attributable to the Italian PE, dividends are partially (95%) exempt from tax in Italy under the participation exemption regime. Result: 1.65% effective tax rate in Italy.

Does tax treatment in Case 1 compared to tax treatment in Case 2 creates a violation the EC Treaty (discrimination, breach of freedom of establishment/free movement of capital?).

Case 3: Interest-Royalties - Fiscally Transparent Entity



Analysis - Issues:

ITACo is a fiscally transparent entity for Italian tax purposes ("checked-the-box" SpA)

FCo pays interest-royalties to ITACo

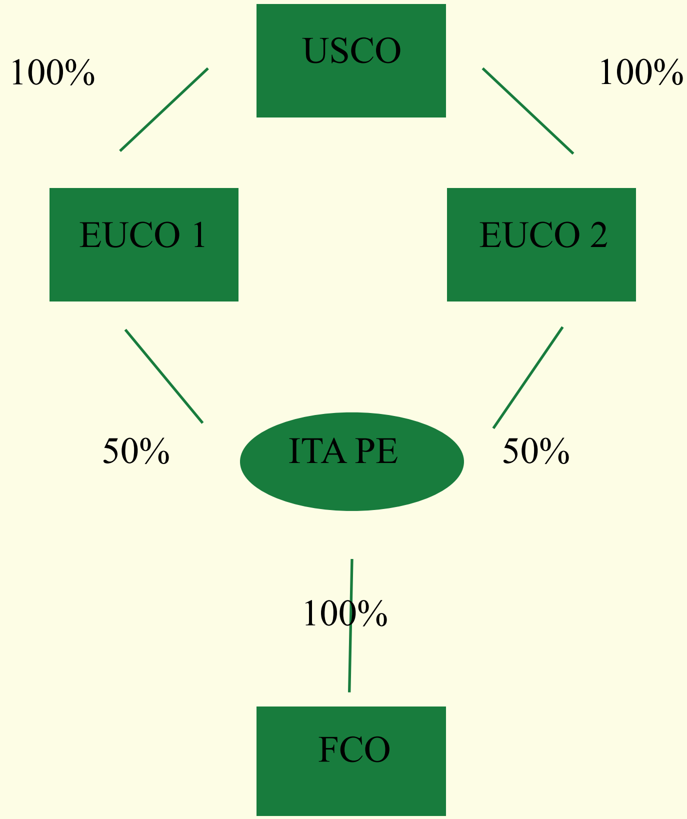
<u>Does the EU Interest and Royalties Directive applies to ITACo</u>? (No, because ITACo is not subject to corporate income tax in Italy. Classification of ITACo in F is not relevant).

<u>Does the EU Interest and Royalties Directive apply to EUCo1-EUCo2</u>? (No, because there is not direct ownership in FCo). What if ITACo is classified as a fiscally transparent in EU? Should it make any difference?

<u>Does F-EU Tax Treaty applies</u>? (No. Answer would be yes if ITACo is fiscally transparent in EU and EUCo1-EUCo2 are non-fiscally transparent in their owns jurisdictions).

<u>Does F-US Tax Treaty applies</u>? (yes, if US treats EUCo1-EUCo 2 and ITACO as fiscally transparent and USCO is not-fiscally transparent in the US).

Case 4: Interest-Royalties - PE



Analysis - Issues:

FCo pays interest/royalties to EUCo 1 and EUCo 2 (or their PE in Italy).

Does the EU Interest and Royalties Directive apply to EUCO1-EUCO2? Yes. Result: no withholding tax in F.

If debt/right is attributable to the PE in Italy, interest/royalty is taxable in Italy on a net basis as income of the PE.

Does tax treatment in Case 4 compared to tax treatment in Case 3 violates the EC Treaty (discrimination, breach of freedom of establishment/free movement of capital?).