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by Marco Rossi

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# Italy Clarifies Rules for Determining Branch Income

*by Marco Rossi*

Italy's tax administration has issued Tax Ruling 44/E, which deals with the determination of the deductible interest expenses of an Italian branch of a U.S. company.

In its March 30 ruling, the tax administration confirmed that Italy's thin capitalization rules do not apply to interbranch loans (that is, loans between the Italian branch and the home office — including external loans entered into by the home office and wholly or partly allocated to the branch — and between the Italian branch and other branches of the same foreign enterprise, located in Italy or abroad).

However, it stated that under the separate entity arm's-length approach mandated by the provisions of articles 7 and 9 of the OECD model income tax treaty (as reflected in the current Italy-U.S. treaty), the Italian branch must meet adequate capitalization requirements and pay market rates of interest. (For the Italy-U.S. treaty, see *91 TNI 27-70* or *Doc 93-31276*.) Therefore, an adequate amount of equity capital should be attributed to the Italian branch for tax purposes, regardless of the actual capital amount entered on the branch's books, and the branch's liabilities and deductible interest expenses should be adjusted accordingly.

The ruling represents an important shift from the books and records method, according to which the taxable income of Italian branches of foreign enterprises should be determined on the basis of the properly maintained books of the branch, to a risk-weighting method requiring the attribution of an adequate equity capital to the branch on the basis of its functions, assets, and risks. And it raises new issues for foreign enterprises — primarily banks and financial institutions — with leveraged direct business operations in Italy.

## Legal Background

The general rules on determination of income of an Italian branch of a nonresident person are contained in article 14 of Presidential Decree 600 of September 30, 1973, and article 152(1) of the Tax Code. They require that nonresident enterprises carrying on a trade or business in Italy through a permanent establishment keep separate books and records relating to the Italian branch's activities on which the transactions carried out through the branch should be properly recorded, a balance sheet reporting the branch's assets and liabilities, and an income statement reporting the branch's profits or losses. The same rules apply for the purpose of determining the profits and losses of a foreign branch of an Italian enterprise for foreign tax-credit computation purposes.

It is a generally accepted view that the transactional books and records method is the only method that can be used to determine the taxable income of the Italian branch and that properly maintained books of the Italian branch would be determinative of its tax results and may not be adjusted, except in extremely rare and easily avoidable circumstances.[1]

[1]It should be noted that the general antiavoidance rule of section 37 *bis* of Presidential Decree 600 of September 30, 1973, has been amended to include balance sheet entries, valuations, and classifications that are relied upon for tax purposes. The new provisions authorize the tax administration to disregard the tax effects of book entries that do not have economic substance but are aimed at tax avoidance purposes. However, this power is limited to book entries relating to stock or other financial instruments to prevent possible abuses of the participation exemption rules. Therefore, it would not seem to be applicable to review the results of a branch's income determination under the books and records method.

With regard to the interest expenses of the Italian branch, Italy's thin capitalization rules do not apply to interbranch loans. They only apply to debt of the branch held or guaranteed by qualified shareholders of the foreign enterprise of which the branch is a part. (For prior coverage, see *Tax Notes Int'l*, Oct. 3, 2005, p. 89.)

The books and records method for the determination of the branch's income, in combination with the nonapplicability of thin capitalization rules to interbranch loans, would make it possible for a foreign company vis-à-vis a similarly situated domestic company to maintain a minimum capital in its Italian branch for Italian tax purposes by entering a minimal amount on the Italian branch's books, and to highly leverage the Italian branch thereby maximizing the branch's interest expense deductions and shifting high-taxed income to the desired jurisdictions.

## Facts and Legal Issues

A U.S. manufacturing company (a worldwide leader in the manufacturing of machinery and equipment for agricultural activities) carries on a business in Italy in branch form. The U.S. company is a public company with no shareholder owning more than 5 percent of its publicly traded stock. The U.S. company has financed its Italian business operation by lending money to its Italian branch and by causing some of its largest shareholders and the Italian branch of its subsidiary financing company based in Luxembourg to extend further credit to the Italian branch through additional loans and factoring contracts. The Italian branch paid or accrued interest to its home office, the shareholders of the U.S. company of which it is a branch, and the branch of the Luxembourgian financing subsidiary of the U.S. company under the loans and factoring contracts, and wished to deduct the interest payments as expenses of the branch for the purpose of determining its taxable income in Italy.

In its application for the ruling, the Italian branch asked Italy's tax administration to clarify the tax treatment applicable to the interest payments, in particular whether the payments may be subject to Italy's thin capitalization rules or may be deducted with no limitations.

The taxpayer's position was that the thin capitalization rules do not apply and the interest payments are deductible with no limitations because, regarding the interest paid or accrued to the shareholders of the U.S. company of which it is a part, the lenders are not qualified shareholders for the purpose of the rules.

## Tax Administration's Position

Italy's tax administration confirmed that interest on interbranch loans is not subject to the thin capitalization rules. This had already been clarified in a general guidance on the rules issued in 2005 and did not pose particular problems.[2]

It also confirmed that the rules do not apply to interest on loans made by the shareholders of the U.S. company, because the shareholders are not qualified shareholders within the meaning of the rules.[3] The analysis could have ended here. (Indeed, it is quite surprising that the taxpayer applied for a ruling on these issues, which appear pretty straightforward.) However, the tax administration took the opportunity to make some broader comments on the matter of determination of deductible interest expenses of the Italian branch of a foreign company.

First, by referring to domestic transfer pricing rules, it stated that it must always be tested under transfer pricing principles, whether interest paid by an Italian branch to a related foreign party (the home office, other branches of the same foreign enterprise, or related foreign companies) is at arm's length, with reference to both the interest rate and the level of the branch's debt, as opposed to its own equity capital.[4]

Second, it referred to the provisions of article 7 of the OECD model income tax treaty (reflected also in the current Italy-U.S. income tax treaty) and took the position that under the separate-entity approach mandated therein, the branch must have adequate capital and its deductible interest expense must be determined with reference to the amount of equity capital that a separate and distinct enterprise engaged in the same or similar business would have to support its activities.

According to the tax administration, if the amount of capital shown on the branch's books is not adequate, additional capital must be allocated to the branch for tax purposes to determine the deductible interest expense of the branch. In imputing adequate capital to the branch, part of the branch's debt can be recharacterized as capital, and only arm's-length interest on debt exceeding the amount of the branch's adequate capital (imputed as above) can be deducted in computing the profits and losses attributable to the branch.

To support its analysis, the tax administration referred to international tax principles and to the need to avoid shifting income to more favorable jurisdictions by overleveraging Italian operations.

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[2]Circular 11/E, issued on Mar. 17, 2005.

[3]Tax Code, article 98(3)(c).

[4]Italy's transfer pricing rules apply also to intra-company dealings, that is dealings between an Italian branch and its foreign home office or other branches of the same foreign enterprise (Tax Code section 110(10) and Circular 32 of Sept. 22, 1980).

The tax administration noted that determining the adequacy of the branch's capital would in each case require a careful analysis of all facts and circumstances, taking into account and properly valuing the assets (tangible and intangible) used, the functions performed, and the risks undertaken by the branch. This language reveals that the tax administration relies on the approach taken by the OECD regarding the attribution of profits to PEs.[5]

In conclusion, according to the tax administration, the determination of the deductible interest expense of the Italian branch is subject to two distinct tests. The first test would require that a sufficient amount of the branch's capital be determined according to a regulatory or market-based benchmark of minimum equity capital based on the branch's assets, risks, and functions and that the branch's liabilities be recharacterized as capital to the extent necessary to impute an adequate capital amount to the branch for tax purposes.

The second test would require that the arm's-length interest rate on the branch's debt be determined under transfer pricing rules. As a result, only the arm's-length interest expense on the residual liabilities of the branch in excess of the branch's adequate (actual or imputed) capital would be deductible for the purpose of computing the branch's taxable profits or losses. (At this point, the taxpayer probably regretted having applied for a ruling on fairly straightforward matters, given the unintended result of raising issues that were considerably more difficult and controversial.)

## Comments

The ruling is difficult to reconcile with Italy's domestic tax law, which requires that the taxable income of an Italian branch of a foreign enterprise be determined in accordance with the branch's books and do not apply thin capitalization rules to interbranch loans. Equally, it may be difficult to reconcile with current income tax treaties (including the Italy-U.S. income tax treaty) that entered into effect before the issuance of the OECD Discussion Draft on the Attribution of Profits to Permanent Establishments, and which may not permit interbranch debt to be treated as equity (thereby disallowing the Italian branch's interest deductions).[6]

However, as the OECD Discussion Draft of the Attribution of Profits to Permanent Establishments indicates, an international consensus is emerging, according to which attributing adequate capital to a PE based on the assets used and the associated risks undertaken by the branch (commonly referred to as the "risk weighting method") is an appropriate method for allocating liabilities among bank branches or other offices to determine the amount of deductible interest expenses allocable to each jurisdiction.[7]

In the ruling, Italy's tax administration has confirmed its willingness to follow emerging international consensus and tax principles developed at the OECD level when addressing international tax matters that arise under Italian law. As a result of this approach, international tax law in Italy is in constant flux, and the use of the special international tax ruling procedure, as the tax administration recommended, may represent an important tool for foreign taxpayers who would wish to achieve certainty on the tax treatment of their transactions or business operations connected with Italy.

Finally, it should be noted that the ruling discusses the new approach for determining the branch's deductible interest expense not only with reference to the banking business but in general terms (actually, it refers to a manufacturing company). Therefore, all industries are potentially interested. ◆

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[5]OECD, Discussion Draft on the Attribution of Profits to Permanent Establishments (PEs): Part II (Banks) (Mar. 2003) (OECD 2003 Permanent Establishment Banks Report).

[6]In the United States, the Court of Federal Claims answered this question in favor of taxpayers in *National Westminster Bank, PLC v. United States*, 58 Fed. Cl. 491 (2003) (*NatWest II*), holding that the old U.K.-U.S. treaty requires that the properly maintained books of the branch be used to determine taxable profits attributable to the branch and that the government is not allowed to adjust those books to require any specific level of nondebt capital. New treaties with the United Kingdom and Japan permit attribution of capital to a branch, so the significance of *NatWest II* will fade away as new treaties adopt the U.S. government's position.

[7]The New York State Bar Association Tax Section recommended that the availability of the risk weighting method be expanded beyond situations specifically contemplated by a treaty and that the method be made available on an elective basis to a broader range of banks than just U.K. and Japanese banks (*see* NYSBA comments on Notice 2005-53 on U.S. branch allocation of interest expense, issued on Sept. 22, 2005).