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by Marco Rossi

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# Italian Tax Office Comments on PE Restructuring

*by Marco Rossi*

Italy's tax administration has issued a ruling regarding the tax consequences of a business reorganization conducted by a foreign company in Italy through a permanent establishment.

In ruling no. 124/E of November 7, the tax administration declared that to the extent that the business formerly conducted through the Italian PE is carried out by the foreign company directly, the shift amounts to a liquidation of the Italian PE that triggers tax on gains relating to the PE's assets, including intangibles such as long-term contracts, customer lists, know-how, special skills, and goodwill.

## Facts

The ruling concerns a U.K. insurance company that in 1992 started insuring risks in Italy on a freedom of services basis (that is, without a fixed base in Italy). In 1997 the U.K. company opened an office in Italy and started insuring risks in Italy, also through its Italian office on a freedom of establishment basis, while continuing the previous business carried out directly by the head office on a freedom of services basis.[1]

Later, the U.K. company started performing all contracts and insuring all risks — including those previously dealt with by its Italian office — directly from its head office, thereby terminating the Italian PE's business.

At that time, it asked the tax authority to clarify the income tax treatment of any profits from collection of premiums, settlement of claims, and recoveries from third parties under the existing contracts that may occur after the termination of the Italian PE's business.

## Tax Administration's Position

The tax administration did not provide a direct response to the taxpayer's requests. Instead, it more generally considered the tax consequences of the transfer of the PE's business to the head office.

It took the position that the transfer of the Italian PE's business to the head office, which would conduct it directly, amounts to a liquidation of the Italian PE.

It also argued that the liquidation of the PE triggers taxation of the unrealized built-in gains on all of the PE's assets, including intangibles such as existing contracts, customer lists, know-how, processes, special knowledge or expertise, and goodwill.

Finally, the tax administration observed that the realization of the gain relating to the PE's assets occurs at the time of the deemed liquidation of the PE and must be recognized for its full amount in the

[1]Legislative Decree no. 174 of March 17, 1995, enacted to implement EU Council Directive 92/49/CEE of June 18, 1992, allowed an insurance company organized in an EU member state to carry on insurance business in Italy according to two different models. The first model involves carrying on the business directly, based on previous notification by the insurance authority of the company's home country to the Italian insurance authority that the company was fully authorized to carry on insurance activities under its home country's insurance law. That model is referred to as freedom of services basis. The second model involves establishing an office in the host country (in this case Italy) in accordance with local insurance laws and carrying on the business through that office. That model is referred to as freedom of establishment basis. Legislative Decree 174 of 1995 has been replaced by Legislative Decree no. 209 of September 7, 2005, which contains all rules on private insurance activities.

**(Footnote continued in next column.)**

tax year in which the transfer takes place, regardless of the fact that the existing contracts may continue to be handled through the PE until their expiration.

With that observation, the tax administration would seem to imply that the deemed liquidation results in an acceleration of the recognition of income attributable to the PE's existing contracts at the time of the business transfer. The tax administration, however, failed to provide any guidelines for how the income should be computed, especially when — as it is the case for insurance contracts — the outcome of claims, settlement, and recoveries under the contracts can be assessed only when the contracts are terminated and when the actual existence of any profits is almost impossible to be determined in advance.

## Tax Code Provisions

The Italian Tax Code provisions support the tax administration's position. Article 151, paragraph 1 provides that foreign entities are subject to corporate income tax in Italy on their Italian-source income. According to article 23, business profits are Italian-source income if they are attributable to a business conducted through a PE in Italy.

Under article 86, business profits subject to corporate income tax include gains from the disposition of business assets. For that purpose, disposition includes the transfer of the assets out of the business or the distribution of the assets to shareholders who no longer use them in the business. The rationale of the rule is that when the business assets cease to be used in a business to generate potentially taxable profits, tax must apply to any unrealized gain built into those assets.

The transfer of a PE's business to the foreign head office is similar to a transfer of the PE's assets out of the business, in a sense that those assets cease to be subject to Italian tax jurisdiction and are no longer able to generate Italian taxable income. Therefore, that is sufficient to trigger the tax on the built-in gain of the PE's assets deemed transferred out of the relevant Italian business.

Also, article 151, paragraph 2 expressly provides that Italian-source business profits taxable to a foreign company engaged in business in Italy include gains relating to the assets used in the Italian business.

Typically, tax treaties based on the OECD model do not prevent source taxation of gains arising from disposition of a PE in the source country (article 13, paragraph 2 of Italy-U.S. tax treaty).

## Implications of the Ruling

The significance of the ruling is that it characterizes the fact that some functions and services previously performed by the PE (insurance of Italian risks on a freedom of establishment basis) are transferred to and carried out by the head office (which insures the same risks on a freedom of services basis) as a liquidation of the PE's business, which should trigger taxation of unrealized gains on the PE's assets under the rules of article 86 and article 151, paragraph 2.

A second significant aspect of the ruling is that it applies the above-mentioned rules to intangible assets attributable to the PE, including customers, long-term contracts, and goodwill.

Potential far-reaching implications of the ruling include the risks that, in the case of restructuring an Italian business through the stripping of functions from local entities to the parent company or other foreign entities of the group, the restructuring could be viewed as a potential termination (reduction) of part of the business conducted by the local entity, with consequent recognition of gain on assets attributable to the local entity's stripped out business, including long-term contracts, customer relationships, and goodwill.

In general, that kind of restructuring should be carefully planned and implemented to avoid negative tax consequences. ◆

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