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Tax-related developments in Italy in 2007 included new provisions enacted with the Budget Law for 2007 and the related Tax Act, which took effect on January 1, 2007. New case law included important decisions regarding the characterization of a subsidiary as a permanent establishment of the foreign parent. Administrative pronouncements included rulings and administrative guidance on the newly enacted real estate investment company regime and trust legislation and the application of Italian controlled foreign corporation rules. Italy enacted rules amending the EU parent-subsidiary and interest and royalties directives. Finally, the tax treaty with Syria entered into force, and the tax treaty with Armenia was ratified.

Legislative Developments

2007 Finance Law

Tax measures enacted at the end of 2006 for the 2007 Finance Law took effect. The new provisions included a new tax regime for publicly traded real estate investment companies, new rules on tax treatment of trusts, new requirements for preferential tax treatment of employee stock options, and the reenactment of the estate and gift tax.

SIIQ Regime

Companies whose primary business activity is real estate rental business could elect to be treated as publicly traded real estate investment companies (*società di investimento immobiliare quotate,* or SIIQs). Under the SIIQ tax regime, income derived by an SIIQ from the lease of rental real estate is not subject to corporate income tax and regional production tax (IRAP), and dividends distributed by an SIIQ out of its exempt rental income are subject to 20 percent withholding tax (reduced to 15 percent for dividends out of profits from rental of property used as a home or private residence).

Only publicly traded companies can elect SIIQ status. However, under a joint election, SIIQ treatment can extend also to 95-percent-owned privately held subsidiaries of an SIIQ. SIIQ status requires that no shareholders own directly or indirectly more than 51 percent of the SIIQ's stock, and at least 35 percent of the SIIQ's stock must be owned by shareholders owning individually no more than 1 percent of stock; real estate rental activity must be the company's primary business; and the company must currently distribute at least 85 percent of its annual profits derived from real estate rental activity. Real estate rental activity is deemed to be the company's primary business if at least 80 percent of the company's assets are real estate rental assets and at least 80 percent of the company's annual revenue is derived from real estate rental profits.

Upon election, real estate property owned by an SIIQ is stepped up to fair market value, and the deemed gain is subject to a flat 20 percent tax in lieu of ordinary income taxes. The same treatment applies for a contribution of appreciated real estate to an SIIQ. Real estate rental income of an SIIQ is exempt from corporate-level taxes. Dividends distributed by an SIIQ out of its exempt income are subject to 20 percent withholding tax, and 15 percent for dividends out of profits derived from rental property used as a home or private residence. On October 24, 2007, the Ministry of Finance issued a decree implementing the new SIIQ tax regime.

Trusts

Trusts are generally treated as taxable entities (subject to corporate income tax). However, trusts with identified income beneficiaries (appointed either in the trust agreement or by the trustee) are treated as fiscally transparent — that is, their income is attributed to the income beneficiaries regardless of distribution and taxed directly on them. If income beneficiaries are entitled only to part of the trust's income, the trust is treated as partly fiscally transparent and partly taxable (hybrid trusts). Distributions from the trust to its beneficiaries are fiscally irrelevant.

Trusts with a legal seat, place of administration, or principal place of business in Italy are domestic; all others are foreign trusts. Trusts formed in a low-tax jurisdiction not included in the list of countries that allow exchange of information with Italy (white list), and that have at the time of formation at least one grantor and one beneficiary that are Italian persons, are presumed to be domestic (resident) trusts unless the taxpayer proves otherwise. Also, if during the life of the trust an Italian person contributes real estate property to a trust, the trust is presumed to be a domestic (resident) trust unless the taxpayer proves otherwise.

A foreign trust with named beneficiaries is fiscally transparent; consequently, its foreign beneficiaries may be subject to tax in Italy on the trust's Italian-source income.

Transfer of appreciated property to a trust triggers taxation of gain and is subject to gift or estate tax, with exemptions and rates based on the relation between the transferor and the beneficiaries of the corpus of the trust. A subsequent transfer of the trust's assets to beneficiaries is not subject to gift tax.

Employee Stock Options

New requirements apply for benefiting from the preferential tax regime on employee stock options (no tax on the exercise of the option and taxation of gain realized from the sale of the underlying stock at the reduced 12.5 percent capital gains rate). Options cannot be exercised before three years have elapsed from the date of the grant (vesting period requirement), the underlying stock must be publicly traded in an OECD country stock exchange (publicly traded requirement), and the employees must hold a number of underlying shares having a value at the time of exercise that is at least equal to the difference between the strike price and the fair market value of the shares on exercise (built-in gain), for at least five years after the exercise of the options (holding period requirement).

Other Income Tax Measures

Domestic companies engaged in tax-free reorganizations (mergers or spinoffs) or incorporations can step up the basis of the acquired assets (or their own preexisting assets) to fair market value (and increase depreciation and amortization deductions) at no cost, up to €5 million. The step-up is not available for a transaction between related entities.

Unlimited carryover of losses incurred in the first three years of operation is limited to losses arising from a new business activity, and the three-year limitation period runs from the formation of the company. Consequently, for mergers or incorporation transactions, the newly formed acquiring company is not entitled to unlimited loss carryover for losses arising from the acquired (old) business.

Shareholders of a company that elects to be treated as a partnership cannot offset their preelection losses with their distributive share of the fiscal transparent entity's postelection income.

New thresholds to treat a company as a nonoperating company, based on the company's average gross revenue (for the current and two preceding years) to asset ratio, are fixed at less than 2 percent of the value of the stock, 6 percent of the value of the real estate, and 15 percent of other assets (by book value). Partnership interests and financial instruments treated as stock enter into the 2 percent revenue to asset factor. For real estate used as a private residence, the threshold is 4 percent. The minimum taxable income of nonoperating companies is 1.5 percent of the value of the stock, 4.75 percent of the value of the real estate (reduced to 3 percent for private residences), and 12 percent of other fixed assets (by book value).

Antiabuse Rules

Antiabuse rules limiting the deduction of losses, costs, or expenses incurred in transactions with entities based in low-tax jurisdictions (blacklisted countries) were extended to cover costs for the provision of services performed by foreign professional individuals or firms, including accounting and law firms.

Estate and Gift Tax

The reenacted estate and gift tax applies to gifts, transfers at death, and other transfers of assets for no consideration that have the effect of separating the transferred assets from the rest of the assets of the transferor. A typical example is a transfer to a trust, which was previously outside the scope of gift tax. The tax applies at different rates (from 4 percent to 8 percent) and with different exempted amounts (from €1 million to zero), depending on the family relationship between the transferor and the transferee (or trust beneficiary). Foreign persons are subject to estate and gift tax on the transfer of assets located in Italy.

Case Law

The Supreme Court, in judgment 13579/07 issued June 11, 2007, ruled that an Italian operating company, wholly owned by a Swiss holding company, cannot be characterized as the PE in Italy of the foreign parent (for the purposes of treating the Swiss parent as an Italian company, based on its principal place of business in Italy where its subsidiary or PE operates, and subject to the transfer of its stock to inheritance tax in Italy), based only on the total control of the Italian company owned by the foreign parent. The Court held that more evidence should be provided that the subsidiary was merely an instrument through which the parent conducted its business in Italy.

Administrative Developments

Three important rulings were issued to clarify the application of Italian CFC rules for multitier CFC structures.

In ruling 63/E of March 28, 2007, the tax administration stated that for the purpose of excluding from the scope of CFC rules the profits that have been subjected to an effective rate of foreign tax equal to or greater than the minimum 27 percent tax rate applicable in Italy for profits of Italian CFCs (so-called high-tax kick-out), reference is to be made to the aggregate effective tax rate incurred at a group level on the CFC's profits before they reach the ultimate Italian shareholders. Consequently, the profits of a CFC organized in Cyprus, which are distributed currently and taxed on an intermediate company organized in the United States, at the U.S. corporate income tax rate, before they are ultimately distributed out to the Italian shareholders, are not subject to Italian CFC rules because the aggregate foreign taxes (10 percent in Cyprus plus 35 percent less any foreign tax credit in the United States) would exceed the 27 percent threshold.

In ruling 191/E of July 27, 2007, the tax administration affirmed ruling 63/E by stating that although dividends distributed by a first-year subsidiary CFC to its Italian parent are ineligible for the 95 percent exemption because they come from a blacklisted company, to the extent that those dividends derive from profits of a second-tier subsidiary that is not a CFC and have been subject to an effective tax rate at least equal to or greater than the minimum 27 percent rate when realized by the second-tier subsidiary, the participation exemption is granted on the basis that the taxpayer has gained no undue tax advantage by locating the investment in the second-tier subsidiary through the first-tier CFC.

In ruling 235/E of August 23, 2007, the tax administration took the position that the profits of a second-tier CFC that have been taxed currently on Italian shareholders under the CFC rules, when distributed to a first-tier CFC, are dividend income of the first-tier CFC that is taxable again on the Italian shareholders. According to the tax administration, under a literal reading of the statute, the previously taxed income exclusion applies only to distributions from the first-tier CFC to its Italian shareholders out of previously taxed profits of the distributing CFC. That position seems inconsistent with the general principle prohibiting internal double taxation and the conclusions taken in rulings 63/E and 191/E.

In ruling 119/E of May 28, 2007, the tax administration stated that a foreign company's server located in Italy sometimes constitutes a PE of the foreign company in Italy and that the foreign company is subject to tax in Italy on profits attributable to the business activities carried out through that server PE. The ruling does not address the issue of computing the amount of taxable profits attributable to the server PE.

In ruling 41/E of March 29, 2007, the tax administration argued that gains of a foreign factoring company from collection of account receivables owed by Italian debtors in Italy is Italian-source taxable income.

On August 6, 2007, the tax administration issued circular 48/E, containing clarifications and guidance regarding the new rules on trusts.

EU Law

Italy implemented European Community directive 2003/123, which contains amendments to the EU parent-subsidiary directive (with retroactive effect from January 1, 2005).

On February 7, 2007, Italy amended legislative decree 143/2005, which had implemented the EU interest and royalty directive (2003/49/EC of 2003). The exemption now applies to interest and royalties that have become payable (as opposed to accrued) on or after January 1, 2004.

Tax Treaties

The Italy-Syria tax treaty entered into force on January 15, 2007.

With law 190 of October 25, 2007, Italy ratified the Armenia-Italy treaty and protocol, which had been signed in Rome in 2002. ◆

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