

Italy Clarifies Scope of Antiabuse Rule

by Marco Rossi

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Italy's Consultative Committee for the Application of Antiavoidance Provisions (a special branch of Italy's tax administration devoted to the interpretation and application of the antiabuse provisions in the Italian Tax Code) has issued three technical advice memoranda regarding a special antiabuse rule that prohibits a domestic enterprise from deducting costs related to transactions with foreign enterprises located in low-tax jurisdictions.

Relevant Tax Law Provisions

General Rule

Italy's Tax Code section 110(10) provides that costs accrued by domestic enterprises in connection with business transactions entered into with foreign enterprises domiciled in blacklisted jurisdictions are nondeductible in Italy for tax purposes. The provision applies even if the foreign enterprise is an unrelated and independent third-party enterprise, and regardless of the nature and purpose of the transaction. An enterprise is domiciled in a blacklisted jurisdiction for the purposes of section 110(10) if it is incorporated or maintains its legal seat or registered or administrative office or place of business in one of the jurisdictions included in a list issued in January 2002.¹

The term "foreign enterprise" includes permanent establishments located in countries other than the country of the parent entity. Therefore, the rule applies to transactions entered into with a PE located in a blacklisted jurisdiction that is part of an entity resident in a nonblacklisted jurisdiction. According to Italy's tax administration, "domestic enterprise" extends to the PE in Italy of a nonresident

taxpayer. The term "domiciled in a blacklisted jurisdiction" is broad and means resident for tax purposes, organized, located, managed, or conducting its principal business in that jurisdiction. The statute limits blacklisted jurisdictions to those outside the European Union. Therefore, low-tax countries that have become members of the European Union, such as Malta and Cyprus, have been eliminated from the blacklist and are no longer subject to the rule. The term "costs" includes any expenses, losses, or deductions that may reduce the taxpayer's taxable income, including amortization or depreciation deductions and capital losses.

Exceptions

Tax Code section 110(11) sets out two major exceptions to the rule on the nondeductibility of costs, whereby a resident taxpayer is allowed to deduct the costs if it demonstrates that the foreign enterprise mainly carries on a real commercial activity, or that the transaction from which the costs accrued corresponds to a real economic interest of the taxpayer and has been carried out. The two exceptions are alternative; the taxpayer can prove its case under either exception to be eligible to deduct the costs for Italian tax purposes.

Actual Trade or Business Test

The first exception requires that the taxpayer provide sufficient evidence that the foreign enterprise is actually engaged in the effective conduct of a trade or business (actual trade or business test). The term "trade or business" includes the provision of services and the production and distribution of goods. Italy's tax administration has issued guidance clarifying that the trade or business test is satisfied if the taxpayer can furnish documentation concerning the foreign enterprise's trade or business, such as lease contracts for the use of office premises; business utility bills; employment contracts; bank records; invoices issued and received; business licenses or authorizations; or other similar

¹The blacklist was approved by way of a ministerial decree issued on January 23, 2002, and amended by a ministerial decree issued on March 22, 2002, which replaced the Ministerial Decree of April 24, 1992.

documentation.² A foreign entity's organizational documents and balance sheets alone are not sufficient to satisfy the test. The possibility of using this exception depends on the willingness of the foreign enterprise to make available to the Italian taxpayer documentation and information about its business and organizational structure that is often confidential. The exception is rarely a viable solution when the dealing is conducted with an independent third-party foreign enterprise.

Business Purpose/Actual Execution Test

The second exception requires that the taxpayer provide sufficient evidence that the transaction serves a bona fide business purpose and has been executed (business purpose/actual execution test). Regarding the first component of the test, the taxpayer must be able to demonstrate that by purchasing some goods or services from, or engaging in a specific deal with, a blacklisted enterprise — as opposed to any other suppliers of similar goods and services on the market or other enterprise established in another country — it achieves a significant economic benefit in the context, and for the purpose, of the successful conduct of its business. Overall, lower costs (taking into account not only the purchase price of the goods or services, but also all other related costs, such as transportation, insurance, and warehousing) are an example.

Other situations may include the ability to enter new markets, better serve customers, outsource functions, achieve economies of scale, reduce labor costs, and so on. In general, the business purpose test requires a comparison between alternative offers of similar goods and services available on the market, and the existence of a valid business reason to purchase from the supplier established in a blacklisted jurisdiction, in the sense that it provides economic benefits for the purposes of the taxpayer's business.³ Regarding the second part of the test, the taxpayer must be able to provide documentary evidence that the transaction has been carried out. In the context of the purchase of goods and services, that includes proof of:

- the conclusion of the transaction (the order and confirmation of the order, and the distribution contract);
- payment of the purchase price (invoices and bank remittances); and

- the actual shipment and receipt of goods (customs documentation) or provision of services (protocol of completion and delivery of the work).

'Separately Stated' Requirement

A general requirement for either exception to apply is that the costs must be separately stated on the taxpayer's tax return for the year in which they are paid or accrued.

Procedural Aspects

From a procedural standpoint, the taxpayer can apply for an advance ruling to obtain confirmation from the tax authority that costs can be deducted under either the actual trade or business or business purpose/actual execution exception. However, the taxpayer may decide not to apply for an advance ruling. In that case, the tax administration, if it decides to investigate, must send a special notice to the taxpayer before any assessment, and the taxpayer has 90 days from the date of receipt of the notice to provide the required evidence and explanations under either of the exceptions to be allowed to deduct the costs.

Recent Pronouncements

In the three recent rulings addressing the application of Tax Code section 110(10), the consultative committee ruled in favor of the taxpayer in the first two cases and against the taxpayer in the third case.

The first ruling (no. 3, Mar. 8, 2006) concerns a case in which the taxpayer (an Italian marketing subsidiary controlled by a Swiss distributor of machinery and equipment for packaging food owned by a German-based multinational group) wanted to deduct the costs of products purchased from the Swiss distributing company and sold to Italian customers. The taxpayer proved its case under the actual trade or business test. It provided evidence of the Swiss company's active trade or business — namely, financial returns for the two previous years; excerpts from real estate registers concerning ownership of the company's offices; turnover for the two previous financial years; purchasing invoices from the German parent and sales invoices to Swiss clients; a draft of the distribution contract entered into with the Italian company; employee payroll records; and utility bills. The tax administration ruled that the taxpayer had passed the test and reserved its right to verify the facts as alleged and documented by the taxpayer.

The second ruling (no. 4, Mar. 9, 2006) concerns a case in which the taxpayer wanted to deduct costs arising from the purchase of two types of connecting rods from a company domiciled in Singapore. The taxpayer proved its case under the business purpose/actual execution test. It demonstrated that

²More recently, the tax administration issued Circular no. 29/E of May 23, 2003, and Resolution no. 46/E of March 16, 2004.

³The Italian Association of Joint Stock Companies has offered specific comments in that respect in its Circular no. 36, issued on August 5, 2004.

the average prices charged by the Singapore company were lower than prices charged by other national and foreign suppliers of similar products; that similar products from other suppliers required additional work to be put into operation, with consequent additional costs; that the standard product was supplied only by the Singapore company; that the quality of the products of the Singapore company was higher than that of the competitors' products; and that in-house production of the goods would have entailed high costs and disrupted the productive chain and core business. The tax administration concluded that the evidence was sufficient to demonstrate that the transaction corresponded to a real economic interest of the taxpayer, and it reserved its power to ask for specific evidence that the transaction was actually executed (because the ruling was issued before the transaction was carried out).

The third ruling (no. 12, Apr. 28, 2006) concerned a case in which an Italian company member of a multinational group purchased goods from a related company in Taiwan and then distributed the goods in Italy, where it also performed postsale customer assistance services. In the context of a reorganization of the group, the Italian company purchased the goods from another related company based in Singapore, which, unlike Taiwan, is a blacklisted jurisdiction under Tax Code section 110(10). The taxpayer argued that the costs for the purchase of the goods from the Singapore entity are deductible un-

der both the actual trade or business test and the business purpose/actual execution test. The tax administration ruled that the taxpayer failed both tests. For the business purpose (economic interest) test, the taxpayer provided only general explanations as to why purchasing the goods from the Singapore company, as opposed to the R.O.C. company, would be more commercially beneficial, rather than specific evidence that it would result in a cost savings or any other economic advantage. For the actual trade or business test, the taxpayer provided only copies of the organizational documents and the balance sheet of the Singapore company, which cannot demonstrate that the company is engaged in the active conduct of a real trade or business.

Conclusions

Italy's tax administration has taken a consistent position on the antiavoidance rule in Tax Code section 110(10) and has provided clear guidance on the documentation that a taxpayer must provide to pass the test under either of the two exceptions. With careful planning and adequate assistance, the taxpayer should, in most cases, be able to satisfy one of the two exceptions, unless the sole aim of the transaction is tax avoidance and it lacks economic substance. ♦

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