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Italy has enacted a series of tax measures designed to keep its increasing budget deficit under control (by bringing it within the 3 percent threshold provided in the EU stability pact) and to restore its deteriorating public finances. The measures include new corporate tax residency and anti-inversion rules. Law Decree 223 of July 4, converted in Law 248-06, was published in Official Gazette No. 186 on August 11.

Article 35, paragraph 13 of the decree added new paragraphs 5-bis and 5-ter to section 73 of the Tax Code to provide rules for determining corporate residency for tax purposes. The new rules create a presumption that an entity is treated as resident in Italy for all Italian tax purposes unless the taxpayer can prove that the entity should be treated as nonresident under the ordinary corporate tax residency tests of section 73(3).

The presumption applies to entities that control a resident company and are directly or indirectly controlled by resident persons or managed by a board of directors or similar administrative body, the majority of whose members are resident persons.

The new rules contrast the practice of interposing a foreign parent company between an Italian company and its Italian owners to obtain tax benefits such as base erosion through earnings stripping and avoidance of controlled foreign corporation rules. Although the new rules primarily concern Italian-owned corporate groups or companies, as a result of the broad meaning of the control tests, which trigger the application of the tax residency presumption, the rules potentially apply to a wider range of situations in which nonresident taxpayers own Italian companies in joint ventures and share control with Italian shareholders.

The new provisions apply to tax years open on the decree's effective date, July 4, 2006, and all tax years beginning on or after that date. Italy's tax administration has provided some clarifications on the new rules with Circular 28E of August 4.

Corporate Tax Residency Rules

Generally, under Italian law, residency and not nationality[1] determines the tax treatment of an entity: Resident companies[2] are subject to corporate tax in Italy on their worldwide income; nonresident entities[3] are subject to corporate tax in Italy only on Italian-source income.

The rules for determining the tax residency of entities subject to Italian corporate income tax are set forth in Tax Code section 73(3). Tax residency is determined under any one of three alternative tests: legal seat, place of management, and main business.

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[1]Italian (or domestic) entities are entities incorporated or organized in Italy and governed by Italian law (article 25 of Law 5.31.1995, no. 218). They are classified as companies (joint stock companies, limited liability companies, and limited partnerships with capital divided by shares) and partnerships (general partnerships and limited partnership). If resident in Italy, domestic companies are separate taxable entities subject to corporate income tax. Domestic partnerships are fiscally transparent entities and their income passes through to and is taxed on the partners. Foreign entities are entities incorporated or organized abroad and governed by foreign law.

[2]The term "resident companies" refers to domestic entities organized as companies under Italian law and equivalent foreign entities that are resident in Italy for tax purposes and subject to worldwide corporate income tax.

[3]The term "nonresident entities" refers to all entities that are nonresident in Italy for tax purposes. Nonresident entities are treated as separate taxable entities for Italian tax purposes regardless of their legal form and tax classification under foreign law and are subject to corporate income tax on their Italian-source income.

An entity is treated as resident in Italy for tax purposes if, for more than half of a tax year, it has maintained in Italy its legal seat, place of management, or main "object." (Similar rules for determining tax residency of domestic partnerships are set forth in Tax Code section 5(3).)

The legal seat is an entity's registered office as appearing from its organizational documents filed and registered with the Italian Register of Enterprises (or equivalent foreign agency). As phrased in the statute, the test is a bright-line, formal test. However, in applying that test, Italy's courts and tax administration have often referred to the entity's actual seat, not its statutory seat. Actual seat is where superior management, direction, and administration of the entity and more of the strategic, financial, and policy decisions take place.[4] The concept of actual seat elaborated by the courts ultimately overlaps with the place of management test (Central Tax Court, May 22, 1996, no. 2677).

An entity's main object consists of the series of specific business activities that the entity purports to carry on, as defined in the entity's organizational documents (certificate of organization and bylaws). The test is met when the main and substantial activity of the entity as described in the entity's documents is performed in Italy. To the extent that reference has to be made to the entity's organization documents, determination of the main object is also a formal test. However, as with the legal-seat test, the courts and the tax administration have interpreted the statute in a way that shifts the analysis to all facts and circumstances of the case and have held that, to determine the location of the entity's object, reference must be made to the place where the entity's main and substantial activities are actually performed as opposed to where they should be performed in accordance with the entity's organizational documents.[5] Ultimately, this test also overlaps with the actual seat and place of management test. The relevant factors for determining the location of the main business of the entity include: where management activities are carried out; location of main office building; where the most important books and records are kept; place and currency in which the accounts are maintained; location of shareholders' or directors' meetings; residency of directors and officers; where the activities of the entity are performed; and location of the entity's assets.

The place of management is where the directors meet and conduct their business. If the board does not exercise management and control but simply ratifies decisions taken by others, the place of management is where the shareholders or members exercise control or where outsiders who dictate the decisions of the board actually operate. The statute does not contain bright-line rules, and the law in this area is murky. Generally, if the board of directors systematically ratifies or adopts decisions taken by the senior management, the place of management will be deemed to be where executive officers and senior management employees exercise day-to-day responsibility for more of the strategic, financial, and policy decisionmaking and where the staff conducts more of the day-to-day activities necessary for preparing and making those decisions. In determining the place of management, Italy is willing to follow the OECD explanations issued regarding the place of effective management of article 4 of the OECD model income tax treaty.[6]

All three tests for determining corporate tax residency as interpreted and enforced by the courts and tax administration are highly factual, require extensive inquiry into the taxpayer's business, and are extremely difficult to administer and enforce. Collecting accurate information and evidence regarding all situations and factors that may be relevant for determining the location of actual seat, main place of business, or effective place of management of an entity may be complex and burdensome. Therefore, outside a few simple or clearly abusive situations, the tests work mainly as bright-line tests: Failing proof to the contrary, which the tax administration has the burden to provide, legal seat is the registered office of the entity, place of management is where the directors meet and resolve on the entity's business (typically at the entity's legal seat), and place of business is usually located either in multiple places because of the international business of the entity, or at the entity's home state.

[4] *See* the Supreme Court's decision of December 10, 1974, no. 4172 concerning the case of a Swiss company owning and operating real estate in Italy. According to the Court's decision of June 16, 1984, no. 3604, the entity's actual seat is located where the direction and management of the entity actually take place and where the directors meet. Similarly, the Court's decision of June 9, 1988, no. 3910, stands for the principle that the actual seat is located where the primary direction and management activities of the entity is carried out. The Court of Genoa in its decision of March 31, 1967, held that a Panamanian company had its real seat in Genoa, where it was administered and conducted its business.

[5] Italy has made an observation on the commentary to article 4 of the OECD model income tax convention, stating that "the place where the main and substantial activity of the entity is carried on is also to be taken into account when determining the place of effective management." *See* paragraph 25 of the commentary to article 4.

[6] OECD, "Place of Effective Management Concept: Suggestions for Change to the OECD Model Tax Convention," May 27, 2003, and OECD commentary to article 4, paragraph 24.

The tax administration is responsible for collecting sufficient evidence to demonstrate that the application of any of the above tests should lead to different conclusions. That may occur in theory, but it is extremely difficult and infrequent in practice. As a result, a foreign entity that has its registered office and place of management formally located in its country of incorporation whose directors meet and transact their business at the entity's seat in the foreign country is usually treated as a nonresident entity for Italian tax purposes. In this context, it often takes little planning for taxpayers to keep the location of the entity's management activities within the foreign country (especially when reference is made to superior and strategic management as opposed to immediate day-to-day administration), and the place of management test ends up being as artificial as the place of incorporation test used in the United States.

Given the high degree of formality and manipulability of the tests used to determine the tax residence of companies, taxpayers have been successful in inverting the legal structure of Italian corporate groups by placing holding companies located in favorable tax jurisdictions at the top. Those companies are treated as nonresidents because their seat and where the board of directors and managers meet and conduct their business is in the entity's home country. Taxpayers have then been able to reduce profits subject to high tax in Italy by means of deductible payments (royalties, interest, and rents) to related nonresident holding (or sister) companies. Those payments are free from withholding tax under the EU directives or are subject to reduced withholding tax rates under any applicable treaty and usually are subject to low or no tax in the holding company's jurisdiction.

Anti-Inversion Rules

To contrast that strategy, the government has enacted new anti-inversion rules. The tax administration has stated in Circular 28E that the new rules aim to enforce the place of effective management rule that applies in the tax treaty context, and more general substance-over-form doctrines adopted at the international level.

According to paragraph 5-bis of Tax Code section 73, the place of management of an entity is presumed to be located in Italy (and, therefore, the entity is deemed to be resident in Italy for all tax purposes) when the entity directly controls a domestic company resident in Italy for tax purposes and is directly or indirectly controlled by persons (individuals or entities) resident in Italy or is managed by a board of directors or equivalent management body the majority of whose members are Italian residents.

For the holding company, only direct control applies. For the resident persons controlling the holding company, control may be direct or indirect. In both cases, the existence of control is tested at the end of the holding company's financial year.

For purposes of the rules, control is defined with reference to the provision of Italian company law that defines the concept of controlled company for corporate law purposes, contained in article 2359(1) of the Italian Civil Code. Civil Code article 2359(1) provides that control exists in each of the following situations:

(1) ownership of more than 50 percent of the votes that can be exercised at the shareholders' ordinary meeting (which elects the company's directors);

(2) ownership of a sufficient number of votes to exercise dominant influence at the shareholders' ordinary meeting; and

(3) ability to exercise a dominant influence at the shareholders' ordinary meeting as a result of specific contractual relationships or arrangements.

The third type of control does not require stock ownership or voting power and can be met even for unrelated entities. The first two types of control are based on voting power, not stock ownership.[7] Article 2359(2) of the Italian Civil Code provides that for purposes of the voting power test of (1) and (2) above, votes owned through controlled companies, fiduciary companies, and conduits are also included in the computation (indirect or constructive voting power rule).

For resident persons controlling the holding company, control can also be indirect. The statute does not clarify the exact meaning of indirect control and does not provide specific attribution rules. One interpretation may be that control, either based on voting power (situations (1) and (2)) or contractual relationships (situation (3)) is attributed in full from a lower-tier to an upper-tier member of the group up to the ultimate owners (as long as control exists at each level of the chain). Another interpretation may be that control as defined is attributed to the members of the groups in proportion to the stock or voting power that each of them directly or indirectly owns in a related entity. A third possible interpretation is that voting power is attributed pro rata to each member of the group to determine if there is control at any level.

[7] Voting power held by a resident person regarding stock owned by a nonresident person by operation of law or contract (as for pledge of stock) counts to determine whether control is met and the rules apply.

It is also unclear how indirect control should be tested in case of factual control under section 2359(1)(iii) of the Civil Code in the absence of stock ownership or voting power. On that issue, Circular 28E states that the rules apply when more than one holding company is interposed between the Italian controlled company and the ultimate Italian resident owners. In that case, if the control test is met along the chain, there may be a cascading effect that could result in all of the intermediate holding companies being deemed to be resident in Italy. The rules also apply for a resident company and nonresident sister company controlled by the same resident persons.

If the presumption applies, the entity is treated as resident in Italy for all tax purposes. The most immediate effect is that the entity will be subject to tax in Italy on its worldwide income and must fulfill all related filing and reporting obligations. Equally important, the deemed resident entity is subject to withholding tax obligations for all payments for which withholding tax is due in Italy, such as interest, royalties, rents, or dividends paid to nonresident persons, or interest or royalties paid to resident individuals not engaged in a trade or business. Failure to properly fulfill withholding tax obligations is sanctioned with civil and criminal penalties.

To rebut the presumption, the taxpayer is asked to provide clear and convincing evidence that the entity's place of effective management is located not in Italy but in a foreign country. For that purpose, the taxpayer must provide adequate proof of all relevant facts and situations that demonstrate a real link between the management of the company and the foreign country (Circular 28E, paragraph 8.3).

EC Law and Tax Treaties

The rules apply to any entity (domestic or foreign) for which the relevant control is met. Therefore, there is no direct discrimination based on nationality. There is also no indirect discrimination based on residence, because the rules apply for the purpose of determining an entity's tax residency, which before their application, has not been determined.

Italy's tax administration in Circular 28E points out that, according to ECJ case law, EU member states are free to determine the relevant connections between a taxpayer and the state as a basis for asserting state's jurisdiction to tax.[8] It also noted that the presumption is rebuttable; therefore, the proportionality principle would be respected. However, despite the language of the statute, the rules are conceived to apply to foreign entities, which are prima facie nonresident entities under Italian tax law because they have their seat and formal place of administration abroad.

In that particular situation, the rules shift from the tax administration to the taxpayer the burden to prove all the facts and circumstances that would establish the tax residency of the foreign entity, which otherwise would be deemed to be resident in Italy for tax purposes (without further inquiry). By so doing, the rules create obstacles to taxpayers that want to operate or invest in another EU member state, and the rules may be deemed to be in breach of the EC Treaty's freedom of establishment or movement of capital provisions. Because the rules apply on a general basis and are not strictly limited to abusive situations, any violation of those freedoms may not be justified on the basis of the need to combat tax evasion.

Regarding the interaction with tax treaties, Italy's tax administration has observed that treaties do not interfere with the internal rules of each country that establish criteria to determine the tax residency of companies in the contracting state, but they resolve situations of double taxation that may arise from inconsistency between the rules by referring to the place of effective management to assign residency to one of the two contracting states.[9] Because the rules are designed to apply only to foreign companies and apply only in the direction from nonresidence to residence, it may be argued that they breach the treaty's nondiscrimination provision.

Relationship With CFC Rules

Of course, when the rules apply, they displace the CFC rules, if applicable, because the foreign entity is deemed resident and subject to worldwide taxation in Italy on a current basis. ◆

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[8]Reference is made to the ECJ's decisions in *Centros* (C-81/87) and in case C-208/00, which concerned a Dutch company that was considered resident in Germany because the majority of its stock was purchased by German residents.

[9]*See* commentary to article 4 of OECD model income tax treaty, paragraphs 1-7.

(Footnote continued in next column.)