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Italian tax authorities have assessed a tax of €600 million and a penalty of €1 billion on a gain realized from the 2001 sale of a controlling stake in Italian telecommunications giant Telecom Italia, according to a report in the newspaper *La Repubblica*. Only a few years before, Telecom Italia was under state control. It was purchased by Italian private owners.

The owner and seller of the stock was a Luxembourg holding company controlled by the Italian shareholders. The holding company sold the stock at a gain of €2 billion and immediately distributed the gain to its shareholders as a dividend. The gain was exempt from tax under article 13 of the Italy-Luxembourg tax treaty, while the dividends were exempt from withholding tax in Luxembourg and from Italian tax on the shareholders under the EU parent-subsidiary directive. The Luxembourg holding company remained in existence, with gross assets of just €34 million to cover its liabilities.

The Italian tax authorities considered the transaction to be tax evasion, saying it was based on the creation of an artificial foreign entity to hold Italian stock solely to avoid the Italian capital gains tax on the sale of the stock. Tax authorities held the Luxembourg holding company's Italian controlling shareholders and directors jointly liable, along with the Luxembourg holding company, for the tax and penalty charged.

The total amount of €1.6 billion, for which a notice of deficiency was issued to the Luxembourg holding company and its directors and shareholders, is equal to 0.1 percent of Italy's GDP.

Based on the results of an investigation that lasted more than three years, Italian tax authorities concluded that the Luxembourg holding company, which was organized under Luxembourg law and had its registered seat in Luxembourg, was actually managed from Italy, and it is therefore to be regarded as an Italian-resident company subject to tax in Italy on its worldwide income under the place of administration test of article 73 of the Italian Tax Code and the place of effective management test of article 4 of the Italy-Luxembourg tax treaty.

The evidence considered included the following facts:

- the Luxembourg holding company had no employees, staff, offices, or assets in Luxembourg;
- the international law firm that represented the Luxembourg holding company and its shareholders prepared all of the company's board resolutions, minutes of meetings, contracts, and so on out of its Italian office (which was also the Italian domicile of the Luxembourg company), and attended meetings and signed contractual documents in Italy; and
- contractual negotiations and discussions concerning the Luxembourg holding company's business were conducted through an office of the company's main Italian shareholder in Italy, and most of the Luxembourg holding company's shareholders (and directors) are Italian-resident companies or individuals.

Italy's Tax Code determines the tax residency of companies and entities based on three criteria: registered seat, place of administration, and principal place of business.

The place of administration is a facts and circumstances test that resembles the place of effective management test used in tax treaties. It looks at the place where the company is actually managed and where the strategic decisions about the company's business are actually made, regardless of the place where the company's registered office is located or where its board of directors meets to formally ratify such decisions.

With the 2007 Budget Law, Italy's legislature reinforced the residency tests of the Tax Code to combat the common practice of holding Italian companies through nonresident companies organized in other EU member states (typically Luxembourg and the Netherlands) to achieve substantial tax benefits, including the exemption of gains and dividends. Gains typically are exempted under article 13 of a tax treaty between Italy and the other contracting state where the holding company is organized, and dividends are exempt (both from withholding tax and shareholders' tax) under the parent-subsidiary directive.

According to new article 73, paragraph 5-*ter* of the Italian Tax Code, if a foreign company directly or indirectly controls an Italian company at the end of its fiscal year and the majority of its shareholders or the majority of its directors are Italian-resident individuals or entities, the foreign company is presumed to be an Italian-resident company for Italian tax purposes. That presumption can be rebutted, but the burden of proof is on the taxpayer.

As a result of the recharacterization of a foreign company as an Italian-resident company, the foreign company is subject to tax in Italy on its worldwide income.

Because the new provision does not create a new tax residency test, but only a presumption for the operation of the existing place of administration test, it may apply retroactively.

The tax administration's conclusions in the Telecom Italia investigation are in line with the rationale of the new provision and the tax policy that supports it. ◆

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