taxanalysts
Respectfully disagreeable since 1970.

tax notes international

Volume 41, Number 11 ■ March 20, 2006

Italy Addresses Treaties and Transparent Entities

by Marco Rossi

Reprinted from *Tax Notes Int'l*, March 20, 2006, p. 947

(C) Tax Analysts 2006. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Reprinted from *Tax Notes Int'l*, March 20, 2006, p. 947

taxanalysts tax notes international

(C) Tax Analysts 2006. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Italy Addresses Treaties and Transparent Entities

by Marco Rossi

Italy's tax administration, in Resolution 17/E issued January 27, has ruled on the application of tax treaty benefits (specifically, reduced source-based withholding tax) to Italian-source portfolio income (dividends) paid to a foreign fiscally transparent entity.[1]

General International Principles

The OECD model income tax treaty (including the 2005 version) has no general provision on fiscally transparent entities. However, the matter has been discussed in a 1999 report, "The Application of the OECD Model Tax Convention to Partnerships," prepared by the OECD Committee on Fiscal Affairs. The report provides a comprehensive analysis of tax treaty issues related to partnerships, and the commentary to the OECD model income tax treaty incorporates several of its conclusions.

The 1996 U.S. model income tax treaty contains several provisions related to hybrid entities. In particular, article 4(1)(d) contains rules that establish when an item of income derived through an entity that is fiscally transparent (under the laws of either contracting state) is entitled to treaty benefits. U.S. Treasury regulations issued under IRC section 894 follow and expand on the approach taken in article 4(1)(d).

The view at both the OECD and the U.S. level is that treaty-reduced withholding rates for payments made to an entity that is fiscally transparent under the laws of either the source country, the entity's residence country, or the residence country of an owner of the entity are denied unless the payment is treated as "derived by" (U.S. approach) or "subject to tax" in the hands of (OECD approach) a resident of the applicable treaty partner. That requires either that: (1) the entity itself is a nontransparent entity of the treaty partner under its tax rules (that is, it is taxed on its income in its country of residence), or (2) the entity is transparent under the rules of the country in which it is organized, and the payment flows through currently (regardless of whether it is distributed) to the owner of the entity under the tax rules of the treaty partner where the owner resides — which means the entity is fiscally transparent and the owner is not fiscally transparent under the rules of that country.

Regarding payments to a regular hybrid entity,[2] in the first case above, the treaty with the entity's home country would apply. In the latter case, the treaty with the entity owner's home country would apply. If the entity is treated as fiscally nontransparent in its home country, but as fiscally transparent in the home country of some of its owners, and an owner is not itself treated as fiscally transparent in its home country, then the treaty between the source country and the entity's residence country, on one side, and any treaty between the source country and an owner's home country would apply concurrently. In that case, the source country would be bound by both treaties at the same time, and to comply with them simultaneously, the payer should apply the lower of the rate provided by the entity's home country treaty and the owner's home country

[1]A fiscally transparent entity is an entity whose income is treated as income of its owners and is taxable in the hands of the owners (it is treated like a partnership under U.S. tax law). A fiscally nontransparent entity is taxed on its own income (it is treated like a corporation under U.S. tax law).

[2]A regular hybrid entity is treated as fiscally transparent under the laws of the source country and as fiscally nontransparent under the laws of the country in which the entity is organized, or the country of residence of the entity's owners.

(C) Tax Analysts 2006. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

treaty (that is, either the entity's home country treaty rate to the entire amount of the payment, or the owner's home country withholding rate to the owner's distributive share of the payment, whichever is lower).

If the entity is fiscally transparent in its home country, then only the treaties between the source country and the entity owners' home countries would apply (if an owner is not itself fiscally transparent under the laws of its home country). In that case, when the rates provided by various treaties with the entity owners' home countries differ, the payer should apply the withholding rate to an owner's distributive share of the entity's income as provided under the treaty with that owner's home country.

> ***In Italy, there are no statutory or regulatory provisions on the application of tax treaties to fiscally transparent entities.***

For payments to a reverse hybrid entity,[3] treaty benefits are available only to an owner of the entity (if the owner's home country treats the entity as fiscally transparent and the owner as fiscally nontransparent), or to none at all (if the owner's home country treats the entity as fiscally nontransparent or the owner as fiscally transparent). If a reverse hybrid is formed under the laws of the state of source (a domestic reverse hybrid), the savings clause of the treaty precludes treaty benefits regardless of transparency in the owner's home country.[4]

Italy's Tax Principles

In Italy, there are no statutory or regulatory provisions on the application of tax treaties to fiscally transparent entities. The experience on that subject is limited, and administrative and judicial guidance on the topic is almost nonexistent. Under Italian internal law (Tax Code section 73(1)(d)), all foreign entities are classified as separate taxable entities regardless of their classification and tax treatment under the laws of the foreign country in which they are organized. The ruling in Resolution 17/E probably represents the only case in which Italy's tax administration has addressed the problem.

The Ruling

The ruling was requested on behalf of an investment fund organized as a limited liability company under Irish law. According to the facts submitted by the taxpayer and reported in the ruling, the fund is established in Ireland as a common open investment fund operating in compliance with EU law, and it invests in the stock of Italian companies. Its participants consist mainly of foreign pension funds. The fund is used as a vehicle to diversify investments and save costs, and the portfolio income received by it isn't subject to tax in Ireland. The taxpayer applied for the ruling in Italy to obtain administrative guidance on Italy's tax treatment of dividends paid by Italian companies to the fund.

The taxpayer's position, as outlined in the ruling, is that the fund is classified as a separate taxable entity for Italian tax law purposes (in accordance with Tax Code section 73(1)(d)), and, therefore, Italian-source dividends paid to the fund would be subject to a statutory 27 percent withholding tax (in accordance with article 27(3) of Presidential Decree 600 of September 29, 1973). The taxpayer correctly observed that, despite the classification of the fund as a separate taxable entity under Italy's domestic tax law, the Ireland-Italy income tax treaty does not apply because the fund is not subject to tax in Ireland on its income when earned and therefore does not qualify as a resident of Ireland under the treaty.[5]

The taxpayer, however, argued that the benefits of tax treaties concluded between Italy and the fund participants' home countries should apply because the fund is a fiscally transparent entity in its own country of organization, and its income flows through to its participants (and, presumably, is taxed in the hands of the participants in their own country of residence).[6] No reference is made in the

[3]A reverse hybrid entity is treated as fiscally nontransparent under the laws of the source country, and as fiscally transparent under the laws of the country in which the entity is organized (or in which the entity's owners reside).

[4]The general principles on application of tax treaties to partnerships and hybrid/reverse hybrid entities are in the commentary to the OECD model income tax treaty, particularly at paragraphs 5 and 6 (6.1 to 6.7) of the commentary to article 1, and paragraph 8.4 of the commentary to article 4. The OECD report also contains practical examples that illustrate the application of those principles. The U.S. rules are in Treasury regulation section 1.894-1(d). The general understanding is that a treaty reflects a source country's agreement to relieve source-based taxation of income with the expectation, and on the condition, that the residence country will exercise its right to tax the income at home.

[5]That analysis is supported by article 3 of the Ireland-Italy tax treaty (which corresponds to article 4 of the OECD model) and is confirmed in paragraph 8.4. of the commentary to article 4 and in paragraph 5 of the commentary to article 1 of the OECD model. The way in which the entity is classified under the laws of its home country prevails, regardless of the classification under the laws of the state of source.

[6]According to the analysis in paragraph 5 of the commentary to article 1 and paragraph 8.4 of the commentary to

(Footnote continued on next page.)

(C) Tax Analysts 2006. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

ruling to the tax classification and treatment accorded to the fund and its participants under the tax laws of the participants' home countries (that is, if and how the participants are taxed on their distributive share of the fund's income in their home countries). It would seem the taxpayer submitted no information in that regard.

The tax administration agreed with the taxpayer that the Ireland-Italy tax treaty does not apply because the fund is not subject to tax in Ireland on its income. That conclusion holds true even though the fund is classified as a separate taxable entity under Italian internal tax law, and it reflects the general principles on the application of treaties to fiscally transparent entities. The tax administration also argued that in order to establish whether any tax treaty between Italy and a participant's residence country applies (regarding the share of the fund's income allocable to the participant), regard must be given to how the fund's income is treated in the hands of the participant. Italy's tax administration pointed out that under Irish tax law, the income of the fund is not allocated to the fund's participants in proportion to their distributive share of the funds' profits and subject to tax in the hands of the participants. Therefore, according to the tax administration, the benefits of any tax treaty between Italy and the state of residence of a participant of the fund cannot apply. The tax administration referred to paragraphs 3 and 5 of the commentary to article 1 of the OECD model to support its conclusions.

The tax administration's analysis is defective to the extent that it fails to inquire how the fund and its participants are treated under the laws of the participants' residence country. Indeed, according to the general principles analyzed in the OECD report and incorporated in the commentary to the OECD model (which Italy's tax administration refers to in its analysis), the treatment of the entity and its owners in the owners' residence country is determinative of the application of any treaty between that country and the source country.

When establishing whether, in the case of income paid to an entity that is treated as fiscally transparent under the laws of its home country, an entity's owner may be entitled to the benefits of a treaty between the country of source of the income (in this case, Italy) and the owner's residence country, reference must be made to the tax treatment of the income in the owner's country of residence, regardless of how the entity is treated in its home country.[7] If, under the laws of the owner's residence country, the entity is treated as fiscally transparent and the owner is subject to tax on its distributive share of the entity's income, then the benefits of a treaty between the owner's residence country and the source country would apply.[8] If, under the same circumstances, the entity's home country treats the entity as fiscally nontransparent and taxes the entity on its income, the benefits of the treaty between the entity's state of residence and the state of source would apply concurrently.[9] In the latter case, the source country would apply the lowest rate provided under the two treaties.

> ***The ruling probably represents the only case in which Italy's tax administration has addressed the problem of transparent entities.***

Despite the flaws in the tax administration's analysis, the ruling is important for taxpayers and their advisers. The tax administration conducted its analysis by referring to the general principles established in the commentary to the OECD model income tax treaty. Therefore, the ruling confirms that the commentary, in its current version, constitutes valid guidance on the matter and in general for the purposes of interpretation and application of tax treaties, even if they were negotiated and entered into before the commentary existed.[10]

Application of EU Directives

Similar problems arise in the application to fiscally transparent entities of benefits derived from EU directives. Under both the 1990 parent-subsidiary directive (90/435/EEC)[11] (as amended by

article 4 of the OECD model, a tax treaty between the source country (that is, the country where income is derived) and the country of residence of an entity's owner can apply only if, under the laws of the owner's country of residence, the entity is treated as fiscally transparent, and the entity's owner is subject to tax on its distributive share of the entity's income. The taxpayer seems to have made no specific submissions on those two requirements.

[7]See paragraph 5 of the commentary to article 1 and paragraph 8.4. of the commentary to article 4 of the OECD model. The same principles apply under U.S. tax law (article 4 of the U.S. model income tax treaty and regulations under IRC section 894).

[8]That is illustrated in example 4 of the OECD report on the application of the OECD model income tax treaty to partnerships.

[9]This is a double application of treaty benefits, which is illustrated in example 9 of the OECD report on the application of the OECD model income tax treaty to partnerships.

[10]This is significant because the Ireland-Italy tax treaty was negotiated and entered into force before the adoption of the commentary language that the tax administration refers to in the ruling.

[11]Implemented in Italy through Legislative Decree 136 of March 6, 1993.

Directive 2003/123/EC of December 22, 2003) and the 2003 interest and royalties directive (2003/49/EC of June 3, 2003),[12] to eliminate the withholding tax at source on dividend and interest and royalty payments, the payee (which, under the interest and royalties directive must also be the beneficial owner of the income) must be a company resident in an EU member state under the internal laws of that state (and may not be considered resident of a third country under any income tax treaty between its state of residence and that third country) and must be subject to corporate income tax therein with no limitation or possibility of opting out.

Regarding the parent-subsidiary directive, the payee must own at least 25 percent of the capital of the payer, while under the interest and royalties directive, there must be direct or indirect 25 percent stock ownership between the payer and the payee (the beneficial owner). Clearly, the subject-to-tax requirement is not met regarding an entity that is treated as fiscally transparent in its own state of residence;[13] therefore, in this case, the directive benefits do not apply.

The question is whether the benefits may apply in principle when, under the laws of another EU member state, the entity is treated as fiscally transparent (regardless of whether it is fiscally transparent under the laws of the country from which income is derived) and the payments made to it are treated, for tax purposes, as flowing through to another entity resident in another state that satisfies the requirements (that is, to a company resident and subject to corporate income tax in that state on the payments). In that case, a parallel issue would be to determine how the stock ownership requirement is applied for stock owned through a fiscally transparent entity. The taxpayer submitted no comments in that respect, so the ruling addresses none of those problems. ◆

♦ *Marco Rossi is the founding member of Marco Q. Rossi & Associati in Italy and New York.*

[12]Implemented in Italy through Legislative Decree 143 of May 30, 2003.

[13]By definition, that entity would not be subject to corporate income tax in its home country.

(C) Tax Analysts 2006. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.