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## **Bavarian IFA October 2010**

**Bolzano, Italy**

**October 16, 2010**

# **Italian Taxation of Multinationals with a special focus on EU law**

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# Italy at a glance – Relevant direct taxes

- 2 relevant direct taxes:
  - Corporate Income Tax
  - Regional Tax
  
- Corporate Income Tax rate: 27,5%
  
- Regional Tax: 3,9% up to 4,82% (depending on the Region in which the company is located)
  
- Consolidated taxation
  - 50% participation threshold
  - Election for three years (renewable)
  - The controlling parent company or P.E. has to be resident in Italy

# Italy at a glance – Dividends

## ■ Inbound dividends

- General regime: 95% exemption → Tax: 5% (taxable base) \* 27,5% (C.I.T. rate) = 1,375%
- Dividends deriving from black-listed companies, also via a white-listed holding: no exemption, fully taxable
- Foreign partnerships: considered as non-transparent entities (with the ensuing implications for DTC purposes)
  
- Outbound dividends → withholding tax

Dividend WHT	Non treaty	EU (qualifying for P-S Directive, 10% threshold)	EU and EEA corporations (non qualifying for P-S Directive)	Italy-Germany DTC
	27%	0%	1,375%	10 or 15%, depending on the participation level

# Italy at a glance – Interest payments

- Interest payments to non-residents

- Withholding tax

Interest WHT	Non treaty	EU (qualifying for I&R Directive)	Italy-Germany DTC
	12,5-27%	0%	10%

- C.I.T. regime: for companies other than banks and financial entities, interest payments:
  - are entirely deductible to the extent of the interest income accrued in the same year and
  - for the excess over the interest income, are subject to a deductibility limitation which is equal to 30% of the EBITDA of the company
  - the non-deductible portion of interest expenses can be used within the group (if and to the extent a fiscal unity regime was opted); in this case they can be deducted from the group consolidated income, to the extent of the spare EBITDA capacity of the companies participating to the tax consolidation regime
- Carry-over mechanism is provided with respect to
  - any non-deductible interest expenses (exceeding 30% of the EBITDA) which can be deducted in future years within the relevant available interest income and/or EBITDA baskets
  - the portion of the (30% of) the EBITDA which remained unused in a given year

# Italy at a glance – Royalties

- Royalty payments to non-residents

	Non treaty	EU (qualifying for I&R Directive)	Italy-Germany DTC
Royalty WHT	22,5% (30% WHT rate on 75% of the gross income)	0%	0 (copyright) or 5%

- Capital gains

- 95% participation exemption (subject to certain conditions)

- Non resident companies

- Art. 13, para. 4, Italy-Germany DTC (consistent with Art. 13 OECD Model)  
→ Taxable only in the State of residence of the seller → Capital gains exempt in Italy

## Italy at a glance – Other relevant aspects

- Very strict CFC rules, as a result of 2009 modifications (inspired to modifications of French CFC rules)
  - CFC is applicable to controlled and affiliated companies resident in black-listed countries
  - Subject to certain conditions, applicable also to controlled companies resident in white-listed countries (even within the EU)
- Regime of non deductibility of costs incurred in operations with black listed companies → we will analyze this regime later

- Withholding tax regime applicable to outbound dividends non qualifying for P-S directive
  - Until 2007: 27% WHT (unless applicable DTC), with the possibility to file a reimbursement request for the 4/9 of the WHT upon evidence of taxes paid abroad → effective WHT 15%
  - As from January 2008: 1,375% WHT levied on dividends paid to EU and EEA resident companies
  - Modification inspired by the infringement procedure started by the EC Commission against Italy on the basis of the principles affirmed in *Denkavit Internationaal* (C-170/05) and *Amurta* (C-379/05) judgments

- Final outcome of the infringement procedure against Italy → ECJ judgment (C-540/07) of November 19, 2009
  - Dividends distributed to EU resident companies: “*By making dividends distributed to companies established in other Member States subject to a less favorable tax regime than that applied to dividends distributed to resident companies, the Italian Republic has failed to fulfill its obligations*” under free movement of capital
  - Dividends distributed to EEA resident companies: “*the Italian legislation at issue must be regarded as justified in relation to States party to the EEA Agreement for the overriding reason in the public interest concerning the fight against tax evasion, and as appropriate to ensure the realization of the objective in question without going beyond what is necessary in order to attain it*”

# Transfer Pricing Documentation – Recent provisions - (1)

- Law Decree n. 78 of May 2010 → specific provision on Transfer Pricing Documentation (TPD):
  - In case of adjustment to intercompany transfer prices by the tax authorities, no penalty can be imposed on the taxpayer if the latter:
    - has noticed the existence of appropriate TPD to the Revenue Agency
    - during the audit, provides the tax auditors with appropriate TPD in order to allow the scrutiny of the arm's-length nature of the transactions
  - If the taxpayer fails to provide TPD to the tax authorities during the audit or fails to communicate its existence, the ordinary penalties ranging from 100 to 200 percent of the assessed taxes will be imposed if a transfer pricing adjustment is made
  - Requirements of the TPD have been recently provided by the regulation issued by the Revenue Agency on September 29, 2010

# Transfer Pricing Documentation – Recent provisions - (2)

- Regulation by the Revenue Agency of September 29, 2010 → inspired to the approach of the 2006 EU Code of Conduct on TPD → 2 set of documents:
  - Master File: it should include common standardized information relevant to all the group members, such as a general description of the business and business strategy, the group transfer pricing policy, the transactions involving associated enterprises, and the functions performed and risks assumed
  - Country-Specific Documentation: it should include information such as amounts of transaction flows within Italy, a comparability analysis including contractual terms and functional analysis, an explanation of the particular transfer pricing methods used, and information on internal and/or external comparables, if available

# Transfer Pricing Documentation – Recent provisions - (3)

- Italian subsidiaries of foreign-based multinationals → only the Country-Specific Documentation is required
  
- Foreign-based multinational with an Italian subsidiary which controls one or more foreign companies → Italian subsidiary qualifies as “sub-holding” → both Master File and Country-Specific Documentation are required
  
- TPD in Italian and to be updated on a yearly basis
  
- Formal communication to Tax Authorities re the existence of the required TPD
  - As from 2010 onwards → communication to be made in the annual tax return
  - Previous fiscal years → communication must be filed within 90 days of the issuance of the Regulation (*id est*, by December 28, 2010)

# Tax Audits and Jurisprudence – “Abuse of law” doctrine

- Over the last couple of years several judgments of the Italian Supreme Court have progressively developed an original “abuse of law” doctrine.
- The Court has stated that the ground for a general principle – whereby a transaction is deemed to constitute an abuse of law if its essential aim is to obtain a tax advantage – directly descends from the Constitution and therefore is generally applicable in all taxation matters.
- Consequently, a transaction which constitutes an abuse of law can be disregarded by the Tax Administration even if there is no specific provision of law allowing it
- Another consequence is that there is a risk of challenge even in those cases where the law offers tax regimes which are absolutely alternative and the taxpayer chooses the most favorable one only due to tax reasons
- Tax Authorities have already started using this principle very aggressively, by challenging transactions on the sole basis of the alleged lack of valid business reasons, without inquiring whether the tax advantage obtained by the taxpayer is actually contrary to the purpose of the law

# Jurisprudence – Recent relevant judgments

- Italian Supreme Court n. 4272 of 2010 regarding non deductibility for Italian resident companies of costs incurred in transactions with black listed companies
  
- General remark: strict application of the rule, especially with regard to costs incurred with Swiss resident companies (ruling n. 100/E of 2009)
  
- 2 safe harbour clauses, requiring the Italian company to give evidence, alternatively, that:
  - the black listed company carries on a genuine economic activity
  - the transactions at hand are effective and meet an economic interest of the Italian company

# Italian Supreme Court n. 4272 of 2010

- Background: Agfa Italy incurs costs resulting from transactions with the black listed Agfa Switzerland, European distributor of the Agfa products. The purchased goods are manufactured by Agfa Europe, resident in Belgium
- According to Agfa Italy, the special regime provided for costs with black listed companies infringes the non discrimination clause provided for by the Italy-Switzerland DTC, according to which “*interest, royalties and other remuneration which an enterprise of a Contracting State pays to a resident of the other Contracting State may be deducted [...] under the same conditions as payments made to a resident of the first-mentioned State*” (similar clause present also in the Italy-Germany DTC)
- Judgment: Agfa Switzerland is a “paper company”, lacking an effective economic role in the transactions concerning goods manufactured by the Belgian company and sold to the Italian company. The Court disregards the documentation filed by Agfa Italy, as it does not give evidence of the effective economic role of Agfa Switzerland in the transactions at hand
- As a consequence, the potential infringement of the DTC non discrimination clause is irrelevant, provided that both the domestic and the DTC provisions do not allow for the deductibility of fictitious costs
- The argument concerning the potential infringement of the DTC non discrimination clause is still valid. The judgment, affirming its irrelevance in the case at hand, confirmed to a certain extent that the infringement may exist

## Regional Tax Court (2<sup>nd</sup> instance) of Ancona n. 452 of 22 June 2010 – (1)

- Background: Italian company manufacturing components for the automotive industry and purchasing LCD displays from black listed companies
- The company argued in favor of the deductibility of the costs, provided that the transactions were effective and met its economic interest
- The Tax Administration denied the deductibility of such costs affirming that the company had not given evidence that the purchasing price of the goods was lower than their market value
- Judgment: the Court ruled in favor of the company, stating that it had given sufficient evidence both of the effective character of the transactions and of the economic interest

# Regional Tax Court (2<sup>nd</sup> instance) of Ancona n. 452 of 22 June 2010 – (2)

## ■ Comments:

- Analysis of the “economic interest” criterion: for the first time it has been stated that
  - the taxpayer can freely choose the suppliers, wherever located
  - **the economic interest should be deemed existent if the transaction may potentially result in a profit for the company involved**
  - the economic interest does not exist where the transaction has an evident loss-making character
- Tax Administration position (circular n. 51 of October 6, 2010): the existence of the economic interest has to be determined taking into account all the features of the regarded transactions (price, accessory costs, delivery time of goods, etc..)
  - The existence of an obligation for the Italian resident company to purchase goods from a certain black-listed seller (normally being part of the same group) does not per se constitute evidence of the existence of the economic interest → evidence of objective and specific advantages deriving from the transaction with the black-listed seller is required

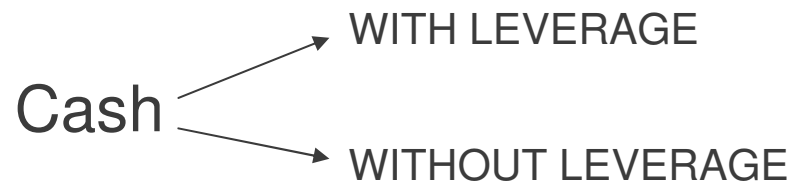
# M&A in Italy – Acquisition of an Italian company - A case study

PURCHASER: Foreign Company (FCO)

TARGET: Italy (ITA)

VEHICLE: To be Discussed (VE)

CONSIDERATION:



# Looking for Tax Effectiveness From Three Perspectives

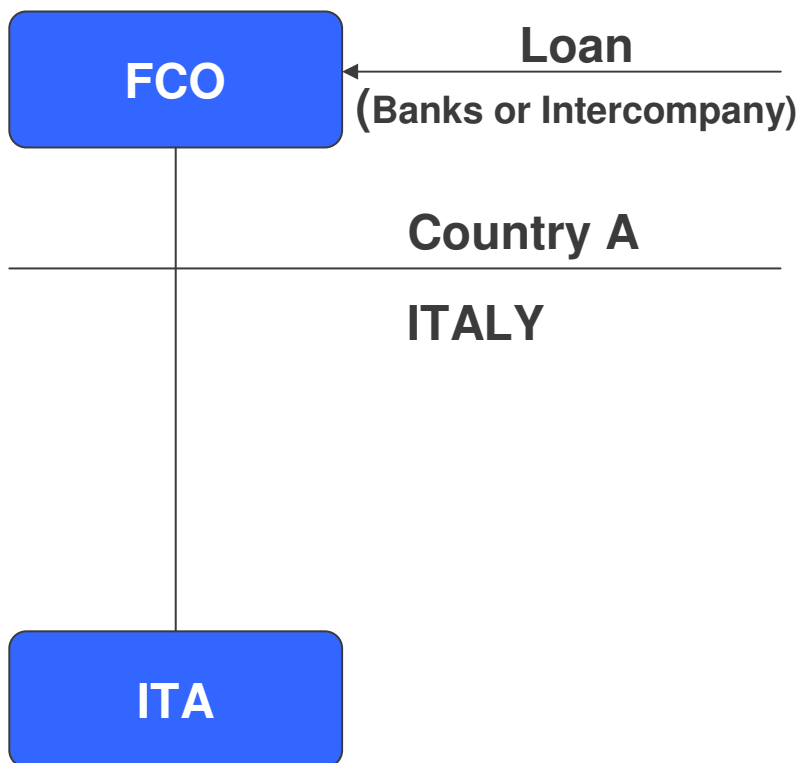
## 1. TAX IMPLICATIONS OF THE TRANSACTION

2. ONGOING TAXATION: Tax amortization of Goodwill/Assets, Tax Relief on Financing Cost, Taxation of Flows of Dividends, Interest, Royalties

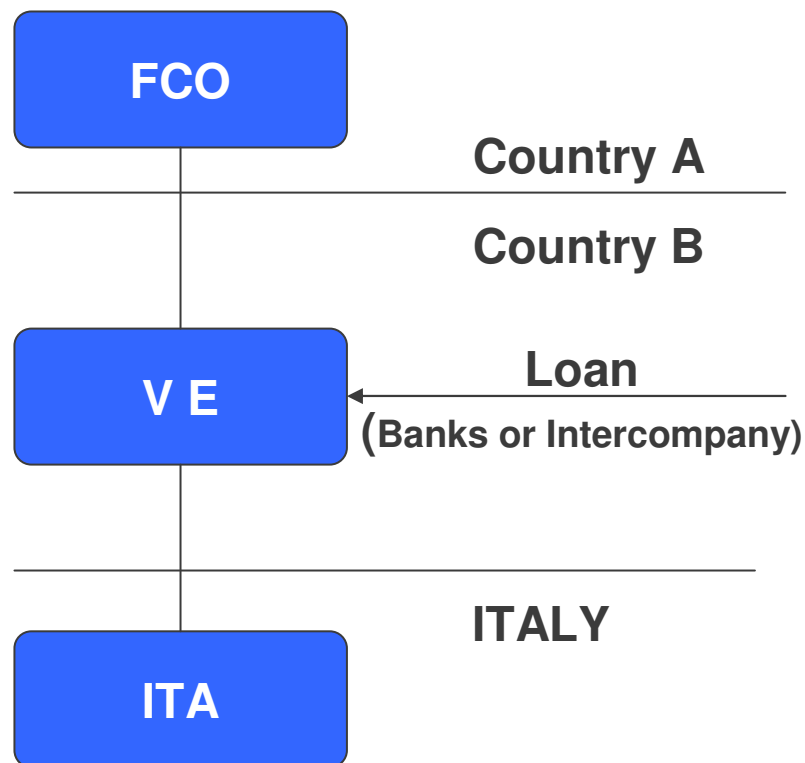
## 3. TAXATION UPON EXIT

# “Traditional” Acquisition Structures

Structure # 1



Structure # 2



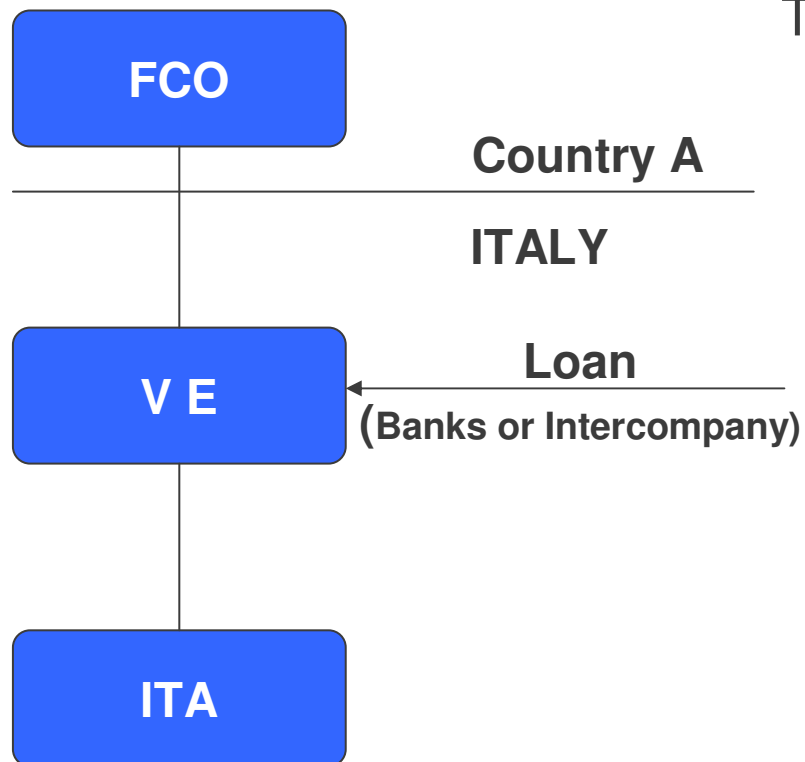
## A “Different” View

- Usual Structures for Cross-Border Acquisition of Italian Target contemplate the use of a Foreign Vehicle

(Typically a Holding located in “popular” Jurisdictions such as the Netherlands, Luxemburg, Switzerland or Off-Shore Countries)

- However:
  - CFC Legislation
  - Lack of Treaty and/or EU Directive Benefits for Off-Shore
  - Increased Attention of Tax Authorities challenging Foreign Residency of Vehicles...

...suggest to consider Different Alternatives, such as an Italian Vehicle



The Use of an Italian Vehicle can ensure Tax Effectiveness of:

1. The Transaction: PEX on Transfer of Shares, Roll-over Relief on Business Contribution;
2. Ongoing Taxation: Tax Relief on Interest, Possible Step-up in Tax Basis; No or Low WHT on Dividends, Interest, Royalties;
3. Exit: No (or Negligible) Capital Gain Tax on Exit.

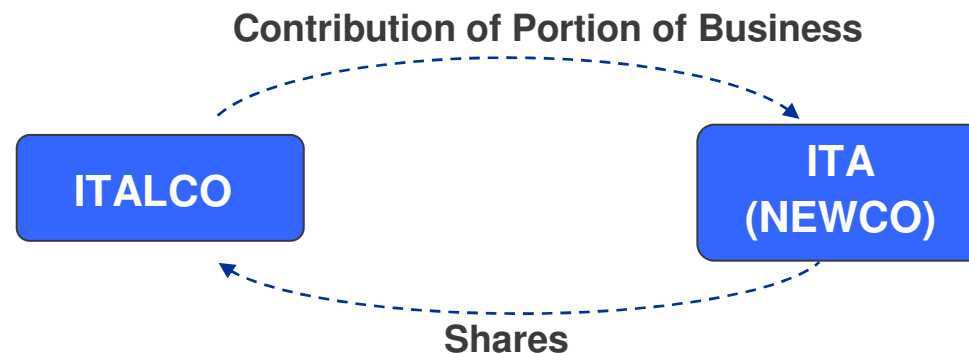
# M&A in Italy – JV Structure – A case study - (1)

## Assumptions

- An Italian Company (ITALCO) wants to transfer a portion of its Business and enter into a Joint Venture Arrangement with FCO.
- The Targeted Ownership is ITALCO 51% - FCO 49%

1<sup>st</sup> STEP – Effective Spin-off and Transfer of the Portion of Business.

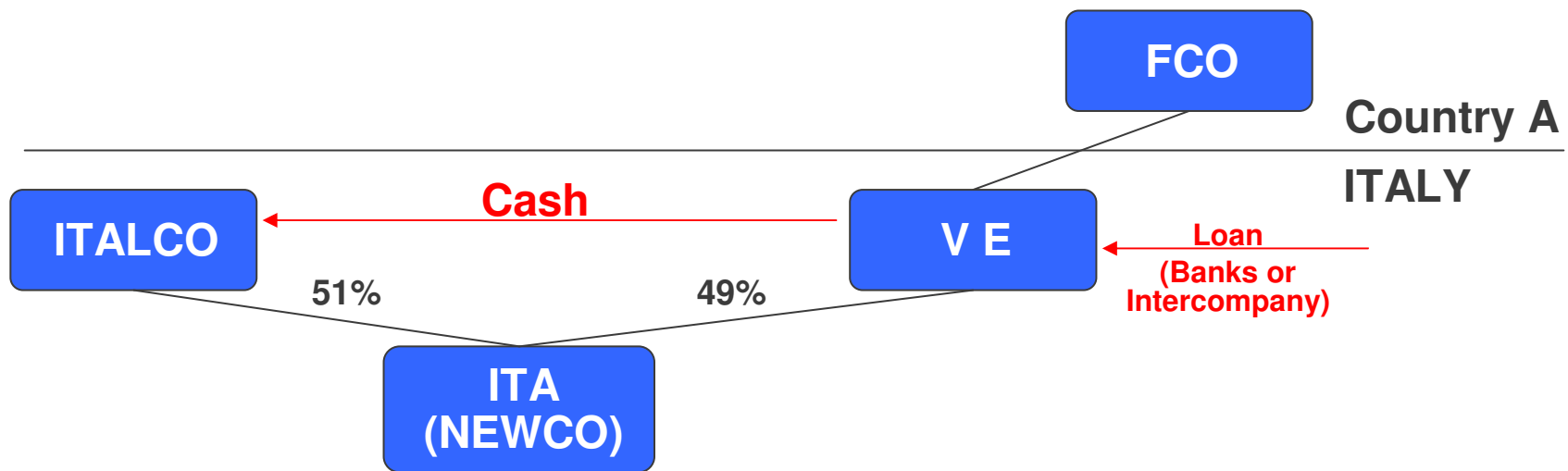
It Must Be an Asset Deal



**Roll-over Relief: Tax Neutral Spin-off**

# M&A in Italy – JV Structure – A case study - (2)

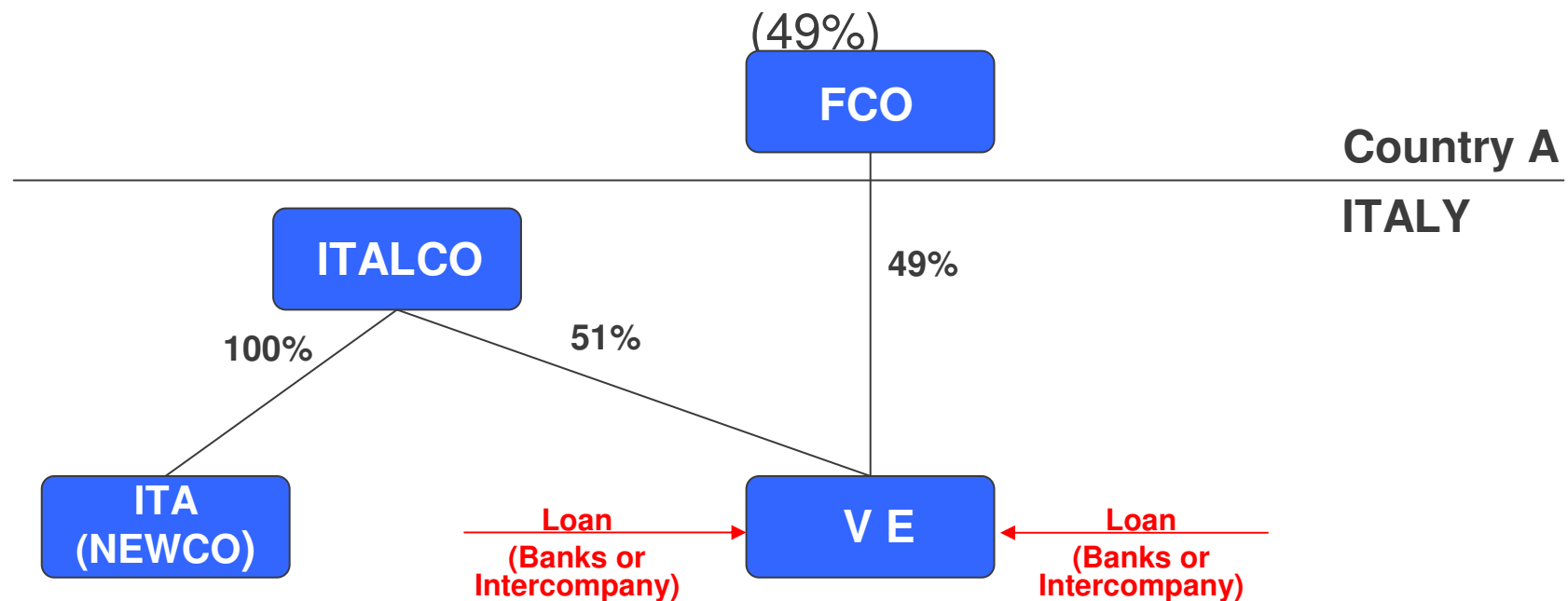
## 2<sup>nd</sup> STEP – Subsequent Sale of 49% Shares in ITA – **No Go**



- Sale of 49% ITA Shares to VE Benefits from PEX (95% Exempt)
- However this Structure is Inefficient as VE does not have Access to Consolidated Group, thus it Cannot Deduct Interest Expenses on Loan (As It does not have any Taxable Profit to Offset)

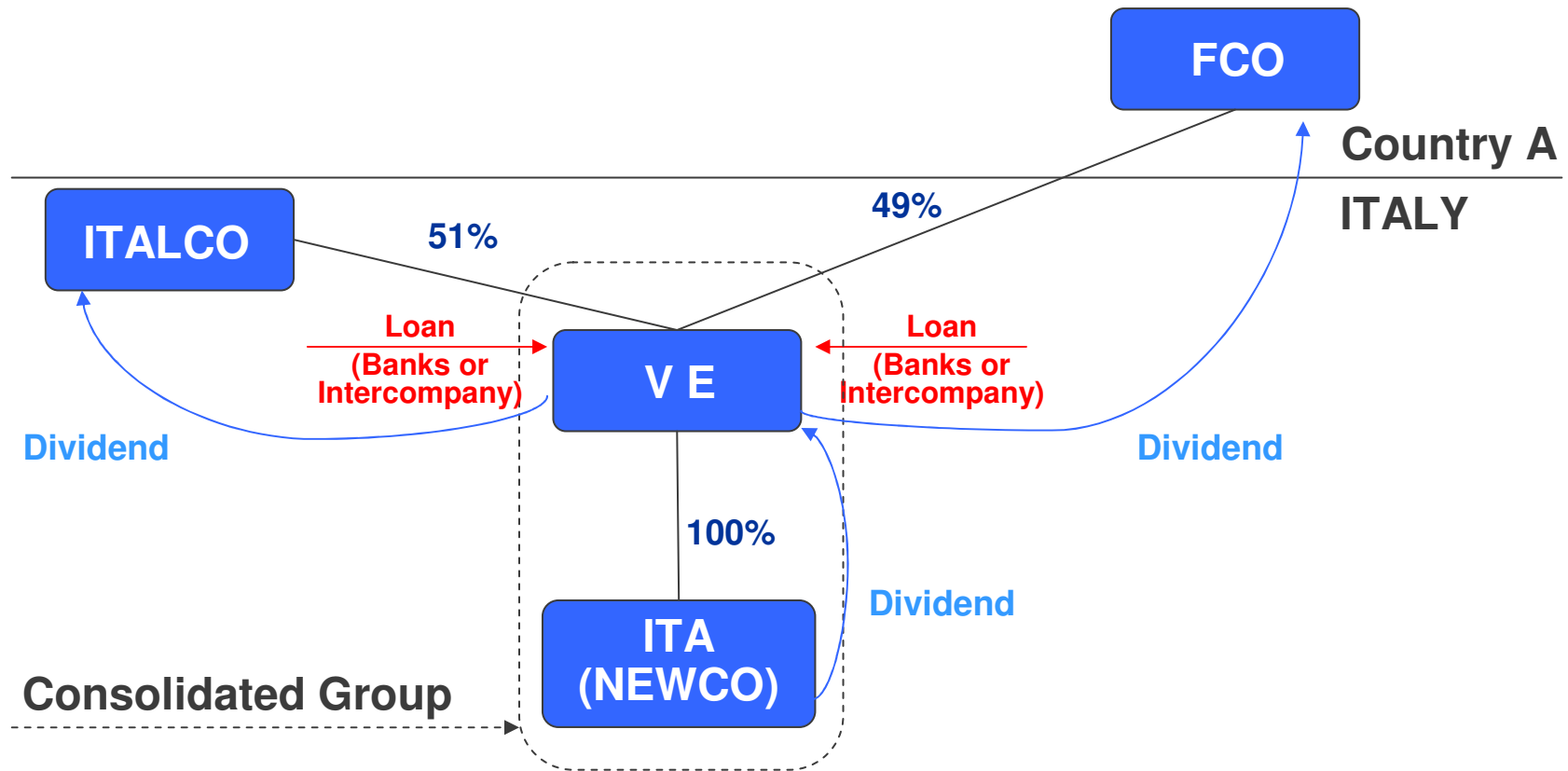
# JV Structure – The Tax Effective Alternative - (1)

2<sup>nd</sup> STEP – The Joint Incorporation of VE by ITALCO (51%) and FCO



# JV Structure – The Tax Effective Alternative - (2)

## 3<sup>rd</sup> STEP – Sale of ITA Shares to VE



# JV Structure – An Alternative Option: Merger of ITA into VE

- Optional Step Up of the Tax Basis of the Assets of ITA at a Cost of an Upfront 12-14-16% Substitute Tax; it would allow full Amortization/Depreciation for C.I.T. and Regional Tax purposes (Aggregate Rate 31.4%);
- This is an Opportunity for Those Assets which can be Quickly Amortized/Depreciated (e.g., Patents, License Rights, Know-How);
- Optionally the Step-up can be Partial, as deemed Appropriate by the Taxpayer

# JV Structure – Tax Effective Alternative – Summary – (1)

Summarizing, This Structure enables the Following:

## 1. TAX IMPLICATIONS OF THE TRANSACTION

- ITALCO does not realize a Taxable Gain in Transferring Its Business down to ITA;
- Joint Incorporation of VE is Tax Neutral;
- The Sale of ITA Shares from ITALCO to VE is 95% Exempt (only C.I.T., No Regional Tax ) =  $5\% * 27.5\% = 1.375\%$

# JV Structure – Tax Effective Alternative – Summary - (2)

## 2. ONGOING TAXATION

- VE Interest Expenses can be Offset against ITA Profit within the Consolidated Taxation;
- As an Alternative to the Consolidated Taxation a Merger is Available: in Addition to Interest Deduction, the Merger offers the Optional Step-Up of the Tax Basis;
- The Seller (ITALCO) can also Benefit from a Tax Effective Financing Structure (for Its 51% Stake);
- Dividends (as well as other Flows: Royalties, etc...) may flow Tax-Free (EU Directives, depending on Jurisdiction of FCO) or Low Treaty Rate

## 3. TAXATION UPON EXIT

- Sale of ITA Shares by VE Can benefit from PEX (95% Exempt) if It occurs after more than 12 Months (then Sale Proceeds can be dividended as above).

If FCO Sells Its 49% in VE, No Italian Capital Gain Tax Should Be Due (Treaty Protection – Article 13 Italy-Germany DTC, consistent with Art. 13 OECD Model)