Italian CFC regime compliant with EU law and double tax treaties

Tax Alert

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The Italian Supreme Court has ruled[1] that the Italian controlled foreign companies (CFC) regime[2] is fully compliant with the freedom of establishment set forth by articles 49 and 54 of the Treaty on the Functioning of the European Union (TFEU) and with the Convention between Cyprus and Italy for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income (the 'Italy-Cyprus double tax treaty').

Introduction

Article 167 of the Italian Income Tax Code, which sets forth the Italian 'CFC regime', provides that an Italian resident taxpayer is subject to tax on income realized by certain CFCs in which the taxpayer directly or indirectly holds the majority of votes or exercises a dominant influence.

The CFC regime applies, firstly, to 'black-list' CFCs. As of the tax year following that in progress on 31 December 2015, 'black list' CFCs are companies resident or established in countries or territories, other than EU Member States, Norway or Iceland, whose ordinary or special tax regimes grant a nominal level of taxation that is less than half the nominal level of corporate income tax in Italy (currently 27.5 percent)[3].

The CFC regime also applies if the Italian shareholder controls companies that are resident of or established in a country (including EU Member States, Norway, Iceland) that is not on the 'black list', if (i) the CFC's effective tax rate is less than half of the Italian effective tax rate that would apply if the CFC were tax resident in Italy, and (ii) the CFC's income is mainly passive (i.e. interest, royalties, dividends) or originates from related-party transactions.

Safe-harbor rules

In order to be exempted from the CFC regime, if an Italian resident taxpayer has a 'black-list' CFC, it must be able to prove, in its application for an advance ruling from the Italian tax authorities or upon request by the tax authorities, one of the following:

(1) Judgment no. 25281 of 16 December 2015.

(2) Contained in article 167 of Italian Income Tax Code.

(3) In the past, reference was made to a 'list' of countries and territories included in the Ministerial Decree of 21 November 2001.

a) that the CFC truly trades on the market of the country or territory in which it is located (the 'business test').

b) that at least 75 percent of the CFC's income is subject to tax in a country or territory whose nominal level of taxation is equal to or higher than 50 percent of the corporate tax rate in Italy, or in the EU, in Norway or in Iceland (the 'subject-to-tax test').

With regard to CFCs that are residents of or established in countries that are not on the 'black list' (i.e. countries whose nominal level of taxation is equal to or higher than half the level of taxation in Italy), an Italian taxpayer can avoid being taxed on the CFC's income only if it can prove that the CFC is not an artificial structure.

Effects of the CFC rules

CFC income is taxed (under a 'transparency mechanism') to the Italian resident shareholder at the standard corporate income rate of 27.5 percent. Taxation is calculated according to Italian business income tax rules, but CFC tax losses cannot be offset by income of the Italian shareholder.

Dividends arising from a 'black-list' CFC that only passes the 'business test' are taxed in full to the ultimate Italian recipient, while dividends paid by a 'black-list' CFC passing the 'subject-to-tax' test qualify for the standard 95-percent exemption.

Facts

The case that judgment no. 25281 of 16 December 2015 decided on concerned an Italian company with a subsidiary in Cyprus, a country that at the time the case was brought was not a member of the EU, and was included in the Italian 'black list' for the purposes of the CFC regime(4). The Italian company submitted an advance-ruling request to the Italian tax authorities in order to prove the safe harbor conditions and exclude application of the CFC rules. However, the Italian tax authorities held that the Cyprus company was a mere holding company that had been set up to hold financial assets, without carrying out any industrial or commercial activities, and that the Italian shareholder had not managed to prove the fulfillment of the 'subject-to-tax test'.

The Italian company appealed the decision before the first and second instance courts, which upheld the Italian tax authorities' position.

The Italian company claimed that the safe harbor conditions (i.e. business test and subject-to-tax test) were fulfilled and that the courts had not taken into adequate account the fact that the Cyprus company had been set up to comply with certain requirements imposed by the local supervisory authorities(5).

(4) Article 1 of the Decree of 21 November 2001.

(5) The ultimate goal was the purchase of a company listed in Cyprus, and this was conditional upon the purchaser being a company set up in Cyprus.

The Italian company held that the unfavorable response to its requested ruling also had effects for the years after Cyprus was included in the EU (1 May 2004), and claimed that this was an infringement of the EU freedom of establishment (as interpreted by the European Court of Justice in the Cadbury Schweppes judgment of 12 September 2006, C-196/04, paragraph 75(6)), and of the EU principle of proportionality.

The Italian CFC regime, even where justified to prevent artificial business arrangements, exceeds what is necessary to combat tax avoidance and therefore infringes on the EU principle of proportionality. The EU Commission(7) clarified that the taxpayer must be given the opportunity, *without being subject to undue administrative constraints*, to produce evidence of any business justification that there may be for that arrangement. In the case of the Italian CFC regime, this condition does not seem fulfilled, as the taxpayer must demonstrate one of the two safe harbor rules in order to disapply the CFC regime, and has no other means to demonstrate that the foreign arrangement is not abusive.

The Italian company also claimed that the CFC regime contrasts with the Italy-Cyprus double tax treaty. According to the tax treaty(8), the mere control of a company resident in one country (Italy, in the case in question) over a company resident in the other contracting country (Cyprus) is not sufficient to allow the first country to tax business income realized in the other country by the controlled company, unless the latter is a permanent establishment of the first (or has a permanent establishment in Italy).

Supreme Court judgment

The Supreme Court decided that the Italian CFC regime is fully compliant with the EU freedom of establishment principle, as interpreted in the Cadbury Schweppes judgment.

A domestic provision under which profits of a CFC are subject to tax in the resident country of the shareholder would be compliant with the EU freedom of establishment principle in presence of either of the following two conditions:

- the CFC is an artificial arrangement aimed at avoiding taxes; or
- the CFC is not actually established in its country or does not have a real business purpose.

(6) Articles 43 EC and 48 EC ('freedom of establishment' – currently, articles 49 and 54 of the TFEU) must be interpreted as 'precluding the inclusion in the tax base of a resident company established in a Member State of profits made by a CFC in another Member State, where those profits are subject in that State to a lower level of taxation than that applicable in the first State, *unless such inclusion relates only to wholly artificial arrangements intended to escape the national tax normally payable*. Accordingly, such a tax measure must not be applied where it is proven, on the basis of objective factors which are ascertainable by third parties, that despite the existence of tax motives that CFC is actually established in the host Member State and carries on genuine economic activities there.'

(7) COM (2007) 785 of 10 December 2007.

(8) Articles 5 and 7.

Under the Supreme Court's ruling, the Italian CFC regime is compliant with the above principle because it does not apply when the CFC satisfies either the (a) business test or the (b) subject-to-tax test.

Moreover, by requiring the taxpayer to demonstrate certain circumstances ('safe harbors') and not limiting the kind of evidence that can be presented, the Italian CFC rule is compliant with the proportionality principle.

Finally, the court decided that the Italian CFC rule does not contradict the Italy-Cyprus double tax treaty. According to the OECD, the entitlement to treaty benefits requires that the taxpayer (i) be a tax resident in one of the contracting countries and (ii) have the legal and economic availability of income (i.e. is the actual beneficial owner of income).

The beneficial ownership clause is there as a general principle of international tax law aimed at preventing taxpayers from taking advantage of double tax treaties in circumstances where they would not be entitled to such benefits ('treaty shopping'). The absence of such clause in a specific provision of a double tax treaty does not undermine its role as a general anti-abuse principle.

Therefore, Italy may tax income that is generated by the CFC but whose actual beneficial owner is an Italian tax resident.

Final remarks

A group of Italian experts (tax professionals and tax law university professors(9)), recently submitted a 50-page complaint against the Italian CFC regime to the European Commission(10).

According to the experts, article 167(8-*bis*) and (8-*ter*) of the IITC, applicable to CFCs that are not in 'black-list' countries, is in contrast with articles 49 and 54 of the TFEU, with article 47 of the Charter of Fundamental Rights of the European Union, and with the principle of proportionality as defined by the EU Court of Justice.

Under Italian tax law (article 167 of the IITC), the taxpayer must verify each year whether the conditions for application of the CFC rules occur, i.e. whether (i) the CFC's effective tax rate is less than half of the Italian effective tax rate that would apply if the CFC were tax resident in Italy, and whether (ii) the CFC's income is mainly passive or mainly derives from infra-group services. Such process can be extremely complex and burdensome.

In addition, if the above conditions seem to be met, the taxpayer must demonstrate through an advance-ruling request or during a tax audit that a CFC located in an EU Member State is not an artificial arrangement, while the tax authorities may deem the contrary. Such proof is often very difficult and the submission of an advance-ruling request each year can be costly, infringing the freedom of establishment and the principle of proportionality.

Additionally, under Italian tax law(11), a taxpayer is not allowed to appeal against an unfavorable response from the Italian tax authorities to a ruling request demonstrating the 'safe harbor' (12). If the taxpayer receives a negative response, it must submit a tax return that is not compliant with the tax authorities' response, and then wait for an assessment of the tax return and appeal against the assessment notice (while immediately paying one-third of penalties and interest). This procedure seems to infringe the right to a fair trial, set forth by article 47 of the Charter of Fundamental Rights of the European Union.

Finally, the Italian CFC rule seems to be in contrast with a recent EU Council directive proposal(13) that states that the CFC rule should not apply to EU companies unless the tax authorities are able to demonstrate that they are fictitious arrangements or carry out non-genuine transactions aimed at obtaining an undue tax advantage. The burden of proof is with the tax authorities in this case(14).

(9) Members of the '*Commissione dell'Associazione italiana dottori commercialisti (AIDC) per l'esame della compatibilità delle leggi e prassi tributarie italiane con il diritto dell'Unione europea'* of Milan.

(10) See Complaint (*Denuncia*) *no. 12 – fiscalità diretta – 'Illegittimità' comunitaria del regime fiscale sulle controlled foreign companies ('CFC rules') applicato a società ed enti con sede in altro stato comunitario, come previsto dall'art. 167, commi 8-bis e 8-ter, del D.P.R. n.917/1986'* of 16 March 2016.

(11) Article 11(1)(b) of Law no. 212/2000 and article 6 of Decree no. 156/2015.

(12) The rules on the advance ruling were recently modified and now the advance-ruling request is not mandatory. As a result, the taxpayer cannot appeal against it.

(13) COM(2016) 26 final Subject: Proposal for a Council Directive laying down rules against tax avoidance practices that directly affect the functioning of the internal market, 28 January 2016, Article 8.

(14) 'Member States shall not apply paragraph 1 where an entity is tax resident in a Member State or in a third country that is party to the EEA Agreement or in respect of a permanent establishment of a third country entity which is situated in a Member State, unless the establishment of the entity is wholly artificial or to the extent that the entity engages, in the course of its activity, in non-genuine arrangements which have been put in place for the essential purpose of obtaining a tax advantage. Paragraph 1 shall not apply to financial undertakings which are tax resident in a Member State or in a third country that is party to the EEA Agreement or in respect of their permanent establishments in one or more Member State'.

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