Italy - Draft of the 'Branch Exemption' implementing decree

Tax Alert

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Legislative decree no. 147/2015, aimed at encouraging the growth and internationalisation of companies[1], introduced the 'Branch Exemption regime' into our tax system. Under the new article 168-*ter* of the Italian Income Tax Code (IITC), as of 2016 (for calendar year taxpayers), resident enterprises may opt for an exemption regime for the profits and losses of their foreign permanent establishments (PEs), as an alternative to ordinary taxation with tax credits.

On 25 February 2016, the Italian Revenue Agency published a draft Statement of Practice ('*Bozza di provvedimento del direttore dell'Agenzia delle entrate'*, hereinafter the 'Draft Decree') on its website containing measures aimed at implementing the new regime. Moreover, the Italian Revenue Agency announced the launch of a public consultation, i.e. a procedure allowing resident companies, academics, professionals, experts and other interested parties to submit their comments and proposals on the Draft Decree by 31 March 2016, to the following email address: branchexemption@agenziaentrate.it.

The main clarifications contained in the Draft Decree are summarised below.

Opting for the regime

The regime can be opted for in the yearly tax return, and is effective as of the tax year to which the tax return refers.

The Draft Decree confirms that the option must be exercised for all the foreign PEs of the resident company (i.e. 'all or nothing')[2]. However, opting for the regime for the PE that was established first automatically binds any other PEs established later, without the need to opt for the regime for each.

In the above-mentioned tax return, the resident company must indicate how many foreign PEs it has and the state or territory in which they are established.

[1] The Decree, which was enacted on 22 September 2015 via publication in Official Gazette no. 220, has been in force since 7 October 2015 (see our Tax Alert of 23 September 2015).

[2] Under paragraph 6 of article 168-*ter*, for PEs that already exist, the regime must be opted for by 2018 (for calendar-year taxpayers), with effect as of the year in which it is opted for.

Termination of the regime

The Draft Decree confirms that a company may not withdraw from the regime. In fact, it clarifies that the regime ceases to apply following the closure of all exempt PEs and in the cases covered by the paragraph '*Business reorganisations*'. If the company subsequently sets up new PEs, it may renew the regime by opting for it again.

Recapture of tax losses

The Draft Decree provides certain clarifications on the claw-back rule for losses realised by PEs before the company opts for branch exemption, an anti-avoidance rule.

If, in the five tax years preceding that in which the exemption regime takes effect, a resident company has offset the tax losses generated by its PE abroad, the taxable income realised by the PE in subsequent years will be subject to tax, and will not benefit from exemption until the tax losses have been absorbed in full (recaptured).

Here, 'losses' means net tax losses accrued by the foreign PE in the five years preceding that in which the exemption regime takes effect, and 'offset' means that these losses were counterbalanced in whole or in part with the taxable income of the Italian parent company, or were transferred to an existing domestic tax consolidated group of which the resident company is part.

The Draft Decree also specifies the consequences of the dissolution of a domestic tax group, where tax losses are attributed to the resident company and a portion of these losses were generated by the foreign PE in the five tax years preceding that in which the exemption regime comes into force.

The recapture is calculated for each foreign state in which there is a PE. Where there are several PEs, located in different states, the Italian parent company calculates both the total recapture and the recapture by country. The total recapture is proportionally allocated to the different states and then to the PEs located therein that contributed to its formation. The recapture by country is relevant for calculating foreign tax credits.

The resident company indicates, in the tax return in which it opts for the regime, the amount of the total recapture and the recapture for each state.

Certain claw-back rules also apply in the case of infra-group transfers of branches that realised net losses in the five years before the branch exemption is opted for. The Draft Decree provides clarifications and extends these rules to transfers of branches to entities outside the group as well.

Recapture of depreciation, write-downs and provisions

If, in the five tax years preceding that in which the regime takes effect, the resident company transferred any assets or liabilities to the PE, including functions and risks, which produced amortization, write-downs or provisions, and these were deducted by the PE, in whole or in part, these amounts will be subject to tax in the hands of the Italian parent company in the following five tax years.

If, in the five tax years preceding that in which the regime takes effect, the resident company transferred goods to the PE whose manufacture or exchange represents the main business of the company, the profit or loss resulting from their disposal is attributed to the exempt branch in proportion to the functions and risks attributed to it.

For the entire duration of the branch exemption regime, the transfer of assets, functions and risks by the resident company to one of its exempt PEs generates capital gains or losses, determined using the criteria set forth in article 152 IITC.

Determination of the income of exempt PEs

The income of an exempt PE is determined based on the profits and losses attributable to the PE itself in accordance with the provisions of the Double Tax Treaty (DTT) in force between Italy and the state in which the PE is established. In the absence of a DTT, profits and losses are attributed and the endowment fund is determined in accordance with OECD principles, i.e. the PE must be considered as a separate entity, carrying out the same or similar activities under the same or similar conditions, taking into account functions performed, risks assumed and assets used.

The Draft Decree confirms and clarifies the principles contained in paragraph 10 of article 168-*ter* IITC, i.e. that the profits and losses of the PE shall be determined according to the provisions of the Italian Income Tax Code and on the basis of a special P&L and balance sheet, as provided for by articles 152 IITC and 14 of Presidential Decree no. 600 of 29 September 1973. The income of the exempt PE must be shown separately in the tax return of the resident company.

Income deriving from infra-group transactions (i.e. those carried out between the exempt foreign PE and the resident company or other group companies) must be determined in accordance with article 110, paragraph 7 IITC (i.e. at arm's length). The resident company may file, also for the foreign exempt PE, transfer pricing documentation, which, where submitted to the Italian Revenue Agency in the event of a tax audit, allows penalty protection from transfer pricing challenges. If the resident company is not part of a multinational group, the documentation only consists of the 'Country File'. For the purposes of this document, 'intra-group transactions' are those between the Italian resident company and each of its exempt PEs, as well as those between these PEs.

The Draft Decree also provides certain clarifications regarding the impact of the branch exemption regime on the Allowance for Corporate Equity (ACE).

Implementation of the provisions of article 167 IITC

As mentioned in paragraphs 3 and 4 of article 168-*ter* IITC, one or more of the foreign PEs may be subject to the provisions of article 167 IITC (CFC rule), where the required conditions are met(3). In such cases, in the absence of the safe-harbour conditions set forth by paragraphs 5, 5-*bis* and 8-*ter* of article 167 IITC(4), the income of the foreign PE is not exempt, and is determined according to the provisions applicable to a foreign CFC of a resident company.

In such cases, the income of the foreign CFC is subject to tax in Italy in the hands of the resident company and is calculated in accordance with the Italian rules on business income; it is subject to separate taxation (i.e., no deduction of losses) at the ordinary corporate income tax rate applicable to Italian companies (currently 27.5 percent).

The resident company must indicate in its income tax return the 'ownership' of a foreign PE, subject to the CFC rule, unless it has obtained a positive answer to a ruling request made to prove the occurrence of the safe harbour conditions or the income of the foreign PE has been taxed in accordance with article 167 IITC. There are administrative penalties for failure to comply with this reporting obligation.

Profits arising from exempt PEs

The Draft Decree briefly describes the effects of a 'black list' branch on the resident company and its shareholders. We expect more details in due course to clarify this further, though.

Profits and losses arising from exempt foreign PEs are not included in the resident company's taxable income.

If one or more PEs are established in one of the states referred to in paragraph 4 of article 167 IITC ('black list' states, i.e. states or territories, other than EU Member States, Norway and Iceland, whose tax regimes, ordinary or special, grant a nominal level of taxation of less than half the level of corporate taxation in Italy), the exemption applies only if the resident company can demonstrate the occurrence of one of the 'safe harbour' conditions, (i.e. the a) business test or b) subject-to-tax test – see footnote 4).

If a resident company distributes the profits generated by its exempt PEs to its shareholders, the latter will generally benefit from the standard 95 percent exemption (when the shareholder is a company). However, if the exempt PE is established in one of the 'black list' states referred to in paragraph 4 of article 167 IITC, 100 percent of the profits will be included in the taxable income of the shareholders (instead of benefitting from the standard 95 percent exemption), with recognition of a foreign tax credit, unless the 'subject-to-tax' safe harbour condition mentioned above is met.

The Italian company must inform its shareholders of the portion of profits distributed that has been generated in the aforementioned 'black list' states, together with the related tax credit. In the absence of such an indication, the profits distributed to shareholders are deemed to have been generated primarily and up to their total amount by the 'black list' exempt branches.

The provisions of the preceding paragraphs also apply to partnerships and sole proprietors. In any case, the profits and losses realised by the exempt PE, as well as the distribution of profits, affect the tax cost of the shares.

Business reorganisations

Business reorganisations (i.e. domestic and EU cross-border company mergers, demergers, contributions, share transfers, etc.) do not interrupt the branch exemption regime if the receiving entity (e.g. the company resulting from a merger) already benefits from the regime or opts for the regime in the tax return for the year in which the reorganisation takes effect. In such cases, the receiving entity will take the assets and liabilities, functions and risks of the exempt branch at the last tax value they had with the transferring entity.

By contrast, if the receiving entity does not opt for the exemption regime, the foreign branch is deemed to be realised and its assets, liabilities, functions and risks are taken at the values they take, under article 166-*bis* IITC, when a company moves its residence to Italy(5).

Special provisions apply when the reorganisation occurs within five years of opting for the exemption regime.

(3) 1) The PE is established in states or territories, other than EU Member States or States in the EEA (i.e. Norway and Iceland), whose tax regimes (ordinary or special) grant a nominal level of taxation of less than half the level of corporate taxation in Italy ('black list' branches).

2) Alternatively, the PE is established in a country (including EU Member States) that is not on the 'black list' as defined above, provided that (i) its effective tax rate (ETR) is less than half of the Italian ETR that would apply if it were tax resident in Italy, and (ii) its income is mainly passive (i.e., royalties, dividends, interest) or originates from related-party transactions.

(4) For protection from the CFC rules, in the case of a 'black list CFC' (according to the above definition), an Italian taxpayer must be able to prove, in its application for an advance ruling or upon request by the tax authorities, one of the following:

a) that, as its core business, the CFC actually trades on the market of the state or territory in which it is located (business test).

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

With specific regard to CFCs resident or established in countries that are not on the 'black list' (i.e. countries that don't have a nominal level of taxation of less 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.

(5) If a non-resident entrepreneur or enterprise changes residence and moves to Italy from a white-list country (i.e., a list of countries that allow an adequate exchange of information with Italy, which is contained in a Ministerial Decree of 4 September 1996), the Italian tax basis of the business assets and liabilities will be their current market value. If the move is from a country that is not on the White List, the current market value must be determined in agreement with the tax authorities, via the international ruling procedure. If no agreement is reached or requested, the tax basis is the purchase cost, book value or market value: for assets it is the lowest of these; for liabilities it is the highest.

In such an event, the assets, liabilities, functions and risks of the branch are taken at the values they had before the exemption regime was opted for.

The sale or liquidation of the exempt branch does not trigger any tax relevant gain or loss for the resident company.

Should one of the above-mentioned business reorganisations (i.e. merger, demerger, contribution) trigger a taxable gain or loss for an exempt foreign branch, the resident company is not entitled to any foreign tax credit.

Withholding taxes (WHTs)

Exempt foreign branches must levy WHT (at the rate stipulated by Italian tax law or DTT provisions) on payments of interest and royalties to beneficiaries resident in a state other than Italy and the state in which the branch is established, on debts or rights actually connected to the branch itself.

WHT must be levied under the following conditions.

- the state in which the branch is established and the state of residence of the beneficiary of income allow an adequate exchange of information with Italy;
- the state in which the branch is established does not provide for WHT on its outbound payments;
- the beneficiary of income is not identified or, if it is identified, its state of residence does not tax the income it receives.

Tax ruling

The Draft Decree confirms the possibility, already stated in Article 14 of Legislative Decree no. 147/2015, of obtaining a binding ruling from the Italian Revenue Agency on the existence of a PE of a resident company abroad. Such a ruling will be based on the information and documents submitted by the company itself in the ‘standard’ ruling request (under article 11 (1) (a) of Law no. 212/2000).

Double taxation/double exemption or ‘mismatching’

The Draft Decree clarifies, with a few examples, possible cases of double taxation or double exemption that the Italian Revenue Agency may identify during a tax audit or assessment, and the remedies that are adopted. For instance, when the foreign state in which the exempt PE is established does not recognise the existence of the PE, the branch exemption regime stops immediately *ex tunc*, for that PE only.

Exit tax

The Draft Decree provides that instead of the loss recapture mechanism or the use of WHT mentioned above, the resident company may choose to tax the deemed capital gains of all the exempt branches under the so called ‘exit tax’ regime set forth in article 166 IITC for companies that move their residence from Italy to a foreign state.

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