Italy: 'Branch Exemption' implementing regulation

Tax Alert
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Under the 'Branch Exemption' regime, governed by article 168-*ter* of the Italian Income Tax Code (IITC)(1), resident enterprises may opt for the exemption of profits and losses of their foreign permanent establishments ('PEs' or 'branches'), as an alternative to ordinary taxation with tax credits.

The regime has been in force since 1 January 2016 but, in the absence of implementing measures, has remained de facto inapplicable.

On 28 August, the Italian Revenue Agency published Regulation no. 165138 (the 'Regulation') containing measures implementing the new regime(2). The main provisions of the Regulation are summarised below.

Opting for the regime

The regime can be opted for, as of fiscal year 2016, in the tax return of the year when a new PE is set up, and is effective from that year.

Enterprises which already had branches on 7 October 2015 (date of entry into force of Legislative Decree no. 147/2015) can opt for the regime until the tax return of the second year following that in progress on that date (i.e. for calendar year taxpayers, either in the '*Redditi 2017*' tax return, where income of 2016 is declared, in which case the regime runs from fiscal year 2016, or in the '*Redditi 2018*' tax return, where income of 2017 is declared, in which case the regime runs from fiscal year 2017).

The Regulation confirms that opting for one newly established PE automatically binds all the existing foreign PEs of the resident enterprise and any other foreign PEs established later, without the need to opt again for the regime (*i.e.* 'all or nothing').

(1) Article 168-*ter* was introduced by Legislative Decree no. 147/2015, aimed at encouraging the growth and internationalisation of companies. This decree was enacted on 22 September 2015, via publication in Official Gazette no. 220, and has been in force since 7 October 2015 (see our Tax Alert of 23 September 2015).

(2) On 25 February 2016, the Italian Revenue Agency published a draft implementing regulation ('*Bozza di Provvedimento del direttore dell'Agenzia delle Entrate*') - see our Tax Alert of 21 March 2016. The final regulation significantly amends the draft.

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Termination of the regime

The Regulation confirms that a resident enterprise may not withdraw from the regime. However, the regime ceases to apply following the closure (e.g. by sale or liquidation) of all exempt PEs and, in certain cases, following a business reorganisation (e.g. a merger, division or contribution - see below).

If the enterprise subsequently sets up new PEs, it may renew the regime by opting for it again. However, the setup of new PEs in the same country, within three years of termination of the regime, may trigger the application of the general anti-avoidance rule. The enterprise can submit an application for a tax ruling in order to ascertain whether there are potential abusive situations.

Recapture of tax losses

The regime includes certain transitional anti-avoidance provisions, briefly described below.

If, in the five years preceding that in which the exemption regime takes effect, a resident enterprise 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). If, in the preceding five years, both the PE and the resident enterprise have incurred losses, the latter's are deemed to be used first.

Here, 'tax losses' means net tax losses accrued by the foreign PE in the preceding five years (i.e. the sum of taxable income and tax losses realised by the PE during the preceding five years results in a loss); 'offset' means that these losses are counterbalanced in whole or in part by the taxable income of the Italian resident enterprise.

As an addition to the first draft, the Regulation clarifies that the recapture is calculated for each foreign country in which there is a PE ('per country approach'). If, for instance, the enterprise has several PEs in the same country, it must treat them as a single PE for tax loss recapture purposes (i.e. the resident enterprise considers the total amount of net losses realised by all the PEs located in the same country in the preceding five years).

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

The Regulation also includes certain rules on the recapture of tax losses when the resident enterprise has opted for a domestic tax group regime.

Attribution of profit to exempt PEs

The income and free capital of an exempt PE are determined in accordance with the authorised OECD approach, *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 Regulation confirms that the profits and losses of the PE must be determined on the basis of special financial statements, making the adjustments required by the rules on business income contained in the IITC and applicable to Italian resident companies, in compliance with article 152 IITC. The taxable income of the exempt PE must be shown separately in the tax return of the resident enterprise.

Income deriving from intra-group transactions (i.e. those between the exempt foreign PE and the resident enterprise or other group companies resident in Italy) must be determined in accordance with article 110(7) IITC (i.e. at arm's length). The resident enterprise 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 enterprise is not part of a multinational group, the documentation only consists in a 'Country File'.

The Regulation also clarifies the impact of the branch exemption regime on the Allowance for Corporate Equity (ACE).

Implementation of article 167 IITC (CFC regime)

As mentioned in paragraphs 3 and 4 of article 168-*ter* IITC, one or more foreign PEs may be subject to article 167 IITC (the CFC rule), where the required conditions are met[3]. In such cases, if the safe-harbour conditions are not satisfied[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 enterprise.

(3) Alternatively: (1) The PE is established in states or territories, other than EU Member States or EEA States (i.e. Norway, Liechtenstein and Iceland), whose ordinary or special tax regimes provide for a nominal level of taxation of less than half the level of corporate taxation in Italy, i.e. below 50 percent of the combined IRES and IRAP rate (i.e., currently, below 13.95 percent); (2) the PE is established in a country (including EU Member States) that does not have a favourable tax regime as defined above, but (i) the PE's effective tax rate (ETR) is less than half of the Italian ETR that would apply if the PE 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 CFC resident or established in a country with a favourable tax regime (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 (i) at least 75 percent of the income of the CFC is subject to tax in the EU or EEA or 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 or (ii) the ETR of the CFC in the foreign jurisdiction (given by the ratio of taxes actually paid by the CFC to profit before taxes of the CFC) is not lower than 50 percent of either the combined IRES and IRAP rate or the ETR that the CFC would have been subject to in Italy if it had been resident there (subject-to-tax test).

With specific regard to CFCs resident or established in countries that do not have a favourable tax regime (i.e. countries that do not 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.

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To this extent, if there is more than one PE in the same foreign country, and they meet the required conditions, each PE is individually subject to the CFC rule.

In such cases, the income of the foreign PE is subject to tax in Italy in the hands of the resident enterprise and is calculated in accordance with the Italian rules on business income. Therefore, it is subject to separate taxation (i.e. no deduction of losses) at the ordinary corporate income tax rate applicable to Italian companies (currently 24 percent).

By contrast, if in the same country there is more than one PE that does not fulfil the CFC conditions or, being a CFC, fulfils the safe-harbour rules, those PEs are considered as a single PE for the purposes of the branch exemption regime and their total income or losses are exempt.

The resident enterprise must indicate in its income tax return that it owns a foreign PE that is subject to the CFC rule, unless it has obtained a tax ruling confirming that the safe harbour conditions are satisfied or unless 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

Profits and losses arising from exempt foreign PEs are not included in the resident enterprise's taxable income. Profits are deemed to be distributed by the PE when there is a decrease in its free capital, also as a result of a reallocation of functions, assets and risks.

If the exempt PE is established in one of the countries with a favourable tax regime referred to in article 167(4) IITC (see footnote 3), 100 percent of the profits arising from that PE will be included in the taxable income of the resident enterprise (instead of benefitting from the standard 95 percent exemption) when it distributes dividends to its shareholders.

If the 'business test' safe harbour condition is met (see footnote 4), the resident enterprise is entitled to a foreign tax credit; if the 'subject-to-tax' safe harbour condition has been met since the fiscal year when the branch exemption came into effect, the standard 95 per cent exemption applies.

The Italian enterprise must notify its shareholders of the portion of dividend distributions arising from profits generated in countries offering a favourable tax regime. Without this notification, profits distributed to shareholders are deemed to be generated primarily, and up to their total amount, in the countries offering a favourable tax regime.

The rules described above also apply to partnerships and sole proprietors.

Business reorganisations

Business reorganisations (e.g. domestic and EU cross-border mergers, demergers, contributions) do not terminate the branch exemption regime if the recipient (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 tax basis of the assets and liabilities, functions and risks of the exempt branch will remain the same for the recipient as it was before the transfer.

The sale of an exempt branch (which terminates the regime) may trigger a taxable capital gain. If the purchaser is resident, belongs to the same group as the resident enterprise and has not opted for the exemption regime, the consideration is deemed to be equal to the arm's length value of the branch determined as per article 110(7) IITC.

If a non-exempt branch is sold to a resident purchaser which belongs to the same group as the resident enterprise and has opted for the exemption regime, the consideration is deemed to be equal to the arm's length value of the branch determined as per article 110(7) IITC.

Tax ruling

The Regulation confirms that the resident enterprise can obtain a binding ruling from the Italian Revenue Agency on the existence of a PE abroad. This ruling will be based on the information and documents submitted by the resident enterprise in the standard ruling request (under article 11(1)(a) of Law no. 212/2000).

Double taxation/double exemption

The Regulation clarifies that that the Italian Revenue Agency will publish in its website any cases of double taxation, double exemption or tax avoidance involving exempt PEs and identified during tax audits or assessments.

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