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by Luigi Perin

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Italy's Ministry of Finance on June 1 issued Resolution 69/E, addressing issues raised by an Italian bank in reference to the taxation of income arising from its branch office in Romania. The branch office constitutes a permanent establishment for purposes of the Italy-Romania income tax treaty.

The taxpayer noted that the PE's taxable income as determined under Romanian tax rules typically is higher than under the Italian rules. That difference is partly because, under Romanian rules, inflationary increments in real property values are included in taxable income. Accordingly, the taxpayer asked the Italian Finance Ministry's advice about the applicable criteria to determine the PE's costs and deductions and the computation of the foreign tax credit.

## PE's Income and Deductions

The Italian tax authorities indicated that the determination of the Romanian PE's income and deductions for Italian income tax purposes must follow Italian rules, which may vary from the rules applicable in Romania for purposes of determining Romanian taxable income and deductions.

The Finance Ministry also confirmed the principle found under article 7(3) of the Italy-Romania tax treaty, which allows a branch to deduct expenses, including executive and general administrative expenses, incurred by its head office for the purposes of the branch. Although Italian law does not provide detailed rules comparable to the ones set forth in U.S. regulations (see U.S. Treas. reg. sections 1.861-8 and 1.882-5), Italy accepts the principle of reasonable allocation. The Italian authorities have approved the use of apportionment methods for expense items, including interest, in various administrative pronouncements.[1]

## Foreign Tax Credit

To prevent or limit double taxation, Italy's domestic rules provide for a credit for foreign taxes paid. While Italian income tax treaties also contain provisions regarding the foreign tax credit, its practical application follows the domestic rules. The amount of foreign taxes for which a credit can be claimed is subject to a limitation intended to prevent foreign tax credits from offsetting Italian tax on Italian-source income. The limit is equal to that part of the Italian tax that is proportional to the ratio foreign-source income bears to worldwide income, net of loss carryforwards. The limitation amount is computed separately for income derived from each foreign country (the per-country limitation).

In the case addressed by Resolution 69/E, the taxpayer argued that, based on its interpretation of

[1]*See* Ministerial Circular no. 271 of October 21, 1997. *See also* Ministerial Resolution 9/2555 of January 31, 1981, which concerned the proper allocation of executive and general administrative expenses to the Italian branch of a French company engaged in the management of hotels and tourist resorts. In Ministerial Note 9/427 of April 8, 1980, the Italian Ministry of Finance adopted an apportionment method based on worldwide sales to impute interest expense to a PE of an Italian company. However, the Finance Ministry explained that, whenever possible, priority should be given to a direct imputation method, as opposed to indirect apportionment formulas.

the foreign tax credit provisions under article 23 of the Italy-Romania treaty, for purposes of computing the foreign tax credit, the Romanian income tax on income items not currently subject to tax in Italy should be deferred to future periods when those items of income are subject to tax in Italy. The Finance Ministry disagreed with the taxpayer's interpretation and noted that the foreign tax credit is not to be computed separately for different baskets of income, but rather, separately for each foreign country, according to the per-country limitation.

The Finance Ministry also indicated that the carryback and carryforward mechanisms that recently were introduced in Italy's domestic rules for computing foreign tax credits are intended to enable taxpayers to use excess foreign tax credits arising in any given year, including excess foreign tax credits arising from timing differences in the recognition of income in the source and residence countries.

♦ *Luigi Perin, partner, Funaro & Co., P.C., New York*