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by Alessandro Adelchi Rossi

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Multitier Structure Not Subject to CFC Regime, Agency Rules

by Alessandro Adelchi Rossi

The Italian Revenue Agency on March 28 issued a private letter ruling (Resolution 63/E) denying the applicability of Italy's controlled foreign corporation regime to a multitier structure.

Tax authorities ruled that if the taxpayer shows that the CFC paid an effective rate of foreign tax equal to or greater than the minimum 27 percent rate applicable in Italy for Italian-controlled foreign corporations, the income at issue cannot be taxed currently in the hands of the shareholders in Italy.

Legislative Background

Italy enacted CFC legislation in 2001 out of concern about the tax deferral that resulted when Italian persons owned foreign corporations, because Italy generally received no tax revenue until the Italian shareholders of the foreign corporations chose to withdraw dividends.

Under articles 167 and 168 of Italy's Income Tax Code, the CFC regime applies to Italian persons holding at least 20 percent (10 percent if the foreign corporation's shares are listed on a stock exchange) of the stock, by either vote or value, of some Italian-controlled foreign corporations, or otherwise controlling — directly, indirectly, or constructively — those CFCs.

However, not every foreign corporation that meets the control test is subject to the CFC rules. Unlike other countries with more stringent rules, Italy uses a territorial approach, whereby the CFC provisions apply only to controlled entities that are resident in jurisdictions that are deemed by the Italian authorities to have advantageous tax systems.

The CFC rules also target for current Italian taxation any income and earnings of an Italian-controlled foreign corporation, regardless of its type.

However, under tax code article 167(5)(a) and (b), if the Italian shareholder shows that a CFC conducts an active trade or business in the foreign country or that, as a result of its foreign investments, no items of income are effectively sourced in low- or zero-tax countries, the CFC rules do not apply and the income of the Italian-controlled foreign corporation is not subject to current Italian taxation. To claim either exception under article 167(5), taxpayers must first secure a favorable ruling from the tax authorities.

The Tax Case

In the case at issue in Resolution 63/E, the taxpayer is an Italian corporation (ITCO) that wholly owns a U.S. entity (USCO). In turn, USCO owns 100 percent of a corporation organized under the laws of Cyprus (CYCO). CYCO is an intermediary holding company engaged in the management of the interests it holds in several operating subsidiaries and branches. As of 2006, CYCO is subject to corporation tax in Cyprus at a rate of 10 percent. The tax system of Cyprus is among those blacklisted by the Italian authorities.

Because of the passive nature of its activities, CYCO does not meet the active trade or business requirement of tax code article 167(5)(a). Accordingly, ITCO requested the application of article 167(5)(b), the alternative exception to the application of the Italian CFC rules, under which CYCO's income would not be subject to Italian current taxation.

ITCO argued that, in light of the group's organizational structure, if CYCO were to distribute its profits to USCO as dividends, the distribution would not effectively benefit from Cyprus's advantageous tax rates because, in the United States, USCO

would be required to include the full amount received as dividends from CYCO as income and to pay U.S. federal tax on that amount at a rate of 35 percent. Nonetheless, USCO would be entitled to claim a credit against its U.S. tax liability for non-U.S. tax paid by CYCO on the earnings and profits out of which the dividend was paid, subject to limitations under section 904 of the U.S. Internal Revenue Code.

The aggregate amount of taxes paid in Cyprus and the United States on CYCO's income, the taxpayer said in its ruling request, would be higher than the minimum 27 percent rate applicable in Italy for Italian-controlled foreign corporations. Accordingly, ITCO concluded, the income should not be taxed currently in the hands of the shareholders in Italy.

Resolution 63/E

The Revenue Agency ruled in ITCO's favor. While the regular definition of a CFC depends only on the stock ownership test, under the applicable regulations (article 5(3) of Ministerial Decree 429/2001), for issuing a ruling, consideration also should be given to the foreign corporation's income. In other words, the regulations also provide that an income test must be met to claim the exception under tax code article 167(5)(b). Namely, at least 75 percent of the CFC's income should be sourced and fully taxed at ordinary income tax rates in countries other than those deemed by the Italian authorities to have an advantageous tax system.

Citing the ministerial decree, the agency found that the fact that CYCO does not meet the income test is not, in and of itself, conclusive in determining CYCO's CFC status. It said factors that the tax authorities should look at in evaluating the merits of a taxpayer's ruling request include, but are not limited to, the income test provided for in the regulations. Thus, ITC article 167(5)(b) should be given a broad interpretation.

In the agency's view, the legislative intent behind the statutory exception of article 167(5)(b) is to also grant an exception from CFC status when the presence of a CFC in a low-tax country does not result in either the avoidance or deferral of tax, as is the case of CYCO in Resolution 63/E. If CYCO were to be treated as a CFC, its profits would be subject to double taxation because of the tax paid on its income in the United States.

Also, the Revenue Agency noted that, because CYCO's incorporation predates the acquisition of its stock by ITCO, its residence in a low-tax jurisdiction cannot be attributed as an attempt by ITCO to avoid taxes.

Final Comments

While Resolution 63/E does not specify whether USCO is a corporation or a disregarded entity for U.S. tax purposes, according to the Revenue Agency, the ruling is subject to the condition that the taxpayer submit, on an annual basis, evidence of the actual distribution of dividends from CYCO to USCO and of the total amount of taxes paid by the group at the consolidated level.

Under Italian tax procedure, Resolution 63/E is a private letter ruling issued directly to the taxpayer that formally requested advice about the consequences applicable to the discussed transactions. A private letter ruling is not binding on either the taxpayer or the authorities. However, in determining the tax treatment of a transaction, the party that does not rely on a private letter ruling will bear the burden of proving that it had reasonable cause to disregard the ruling, and that there was no willful neglect. ◆

♦ *Alessandro Adelchi Rossi, Funaro & Co., P.C., New York*

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