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The Interest Article Under the Pending Italy-U.S. Tax Treaty

by Alessandro Adelchi Rossi

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The Interest Article Under the Pending Italy-U.S. Tax Treaty

by Alessandro Adelchi Rossi

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The United States and Italy signed a new income tax treaty and protocol on 25 August 1999.[1] The treaty has been ratified by the United States. However, Italy has not yet ratified it. It will enter into force once the instruments of ratification are exchanged.

The treaty provides, as a general rule, that both the source country and the beneficial owner's country of residence may impose tax. For the source country, however, taxation may not exceed 10 percent of the amount of gross interest paid.

That provision is in line with the OECD model treaty. But it is contrary to the position of the U.S. model, which provides for an exemption from source country tax for interest beneficially owned by a resident of the other country to protect the interests of the United States, traditionally a capital exporter country.[2]

In the OECD view, the 10 percent rate may be considered reasonable, considering that the source country is already entitled to tax the profits generated on its territory by investments financed out of borrowed capital.[3]

Beneficial Owner

The term "beneficial owner" is not defined in the treaty and is, therefore, defined under the internal law of the country imposing tax (that is, the source country). For purposes of article 11, the beneficial owner of the interest is the person to which the interest income is attributable for tax purposes under the laws of the source country.

Thus, if, for example, interest arising in Italy is received by a nominee or agent that is a U.S. resident on behalf of a person that is not a U.S. resident, the interest is not entitled to the benefits of article 11 of the treaty.

Conversely, interest received by, for example, a U.K. nominee on behalf of a U.S. resident would be entitled to treaty benefits.[4]

U.S. Domestic Law

Because, in many cases, interest from U.S. sources paid to an Italian resident is exempt from the U.S. statutory[5] 30 percent tax under two exemptions contained in the U.S. domestic law, an Italian resident deriving interest income from U.S. sources may benefit from the article 11 reduced withholding rate only when these U.S. statutory exceptions do not apply.[6]

The first exemption is for so-called portfolio interest.[7] In general, "portfolio interest" means any interest paid on a registered obligation to a

[1]This will replace the current treaty and protocol, which entered into force on 20 December 1985. On 5 November 1999, the U.S. Senate approved the treaty subject to a reservation requiring the removal of the "main purpose" test discussed below and subject to an understanding that the competent authorities would have the authority to obtain and provide information held by financial institutions and others. President Clinton signed the U.S. Instruments of Ratification on 28 December 1999.

[2]However, because the United States has become the world's largest borrower, the increasing role played as a source country for interest has also been taken into account.

[3]*See* OECD commentary on article 11, paragraph 7.

[4]This is the position taken by the Italian government in Risoluzione Ministeriale No. 12/431 of 7 May 1987 and confirmed by paragraph 8 of the OECD commentary to article 11. *See also* paragraph 24 of the OECD commentary to article 1 (personal scope).

[5]*See* Internal Revenue Code sections 871(a) and 881.

[6]In the past, Italian companies could arrange financing structures through a company resident in a country with a treaty providing a zero percent interest-withholding rate. Thus, even when the U.S. statutory exceptions did not apply, Italian companies could avoid even the reduced rate of withholding tax provided by the treaty with the United States. To address these multiple-party financing arrangements designed to avoid U.S. withholding tax, the IRS has issued final regulations under IRC section 7701(l). These regulations are often referred to by tax practitioners as the "conduit financing regulations." As a result, the treaty's reduced rate of withholding seems to be more valuable now than in the past.

[7]*See* IRC sections 871(h) and 881(c).

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non-U.S. person. From a tax-planning perspective, this exemption is sometimes used by Italian investors who choose to receive U.S.-tax-free interest income by lending to owners of U.S. real property rather than receiving rental income by acquiring an ownership interest in real property.[8]

The treaty defines 'interest' less broadly than did the prior treaty.

The second exemption is for "interest on deposits,"[9] if that interest is not effectively connected with the conduct of a trade or business within the United States. Italian residents holding bank accounts with U.S. banks often use this exemption.

On a final note on U.S. domestic law, sometimes, when the "earnings stripping" provisions[10] apply, an Italian company that finances its U.S. subsidiary might find it more beneficial to waive the benefit of the treaty reduced rate of withholding on interest from U.S. sources.[11] By doing so, the U.S. related party of the Italian investor remains entitled to a deduction for any interest paid. In addition, the Italian company might claim on its Italian income tax return a credit for the entire amount of tax withheld in the United States at the statutory 30 percent rate.

Italian Domestic Law

From a U.S. taxpayer standpoint, the 10 percent withholding rate of article 11 provides some reduction of Italian tax otherwise imposed under Italian domestic legislation. For example, interest on loans is generally subject in Italy to a 12.5 percent rate.[12] By the same token, interest on bonds issued by privately held companies is generally subject to a 12.5 percent rate in Italy.[13]

Conversely, the treaty does not provide additional relief for interest income on deposits, bank accounts, public bonds, and private bonds issued by banks and public companies — that is, all types of interest already exempt from Italian withholding[14] under domestic law[15] if derived by a U.S. recipient.[16]

Income Dealt With in Article 10 (Dividends)

From a tax standpoint, the principal advantage of issuing debt as opposed to equity is that, unlike dividends, interest paid on corporate debt is generally deductible by the payor. However, in certain circumstances, a corporation's debt obligations may be treated as equity by the tax authorities, making the "interest" paid on them a nondeductible dividend.

Interest payments treated as deemed dividends would not be subject to withholding under the interest article, because under the last sentence of paragraph 4 income dealt with in article 10 (dividends) is not regarded as interest under the treaty. Rather, article 11 now allows the U.S. to subject contingent interest[17] to withholding tax at the higher (at least when the recipient is an individual) rates applicable to dividends.

Thus, the treaty defines "interest" less broadly than did the prior treaty. This change seems to be a concession to the United States, which in 1993 — concerned that its portfolio interest exemption could be used to avoid withholding tax on income from equity investments — amended its domestic law to exclude certain contingent interest payments (generally, payments in the nature of

[8]There are exceptions to limit the application of the "portfolio interest" rules for, *e.g.*, financing transactions between related parties.

[9]*See* IRC sections 871(i) and 881(d).

[10]*See* IRC section 163(j). In general, these provisions limit the deductibility of interest payments made to related entities (including related non-U.S. recipients) exempt, totally or partially, from U.S. tax.

[11]Under article 169 of the Italian income tax code, if Italian domestic legislation provides more favorable treatment than a treaty, the taxpayer may apply the provisions of domestic law. That benefit provided under Italian law is not restricted by the treaty. *See* article 3 of the treaty protocol, relating to article 1 (personal scope).

[12]*See* D.P.R. 600/1973 art. 26(5). If the recipient is a resident of a tax haven, a 27 percent rate applies.

[13]The 12.5 percent rate applies to bonds payable after at least 18 months if the interest rate on the bond does not exceed either 2/3 or 1/3 of the official discount rate, depending on the type of issue. Otherwise a 27 percent rate applies. *See* D.P.R. 600/1973 art. 26(1).

[14]*See* D.P.R. 600/1973 Art. 26-*bis*.

[15]*See* D.Lgs. No. 239/1996.

[16]*See* D.M. of 4 September 1996. This exemption does not apply if the recipient is not a resident of a country with which Italy has a tax treaty containing an exchange of information provision and is a resident of a tax haven.

[17]Contingent interest generally includes interest determined by reference to receipts, sales, profits, or other cash flow of the debtor.

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"equity participation" rights) from the definition of "portfolio interest."[18]

Exemption From Source Country Withholding Tax

The treaty provides for a complete exemption from source-country withholding tax if the interest is:

- Beneficially owned by a resident of the other country that is a qualified governmental entity owning (directly or indirectly) less than 25 percent of the capital of the person paying the interest.
- Paid on debt obligations guaranteed or insured by a qualified governmental entity of that other country and beneficially owned by a resident of that other country.
- Paid or accrued on trade financing. This exemption, which might make this form of financing very attractive, finds its rationale in that an interest withholding tax imposed on a gross basis "raises a difficult and sometimes insoluble problem for trade financing" because "when the beneficiary of the interest has himself had to borrow in order to finance the operation which earns him interest, the profit he will realize by way of interest will be much smaller than the nominal amount of interest he receives." The consequence can be an obstacle to international trade, because the seller typically passes the costs on to its customer, either through a higher interest rate or through a higher sales price. Accordingly, "the interest is more an element of the selling price than income from invested capital" and should not be subject to withholding tax.[19]
- Paid or accrued in connection with the sale on credit of industrial, commercial, or scientific equipment.

Interest Paid to a Permanent Establishment

The treaty's reduction in source-country tax on interest does not apply if the beneficial owner carries on business in the source country through a permanent establishment located in that country (or fixed base, for an individual who performs independent personal services) and the debt claim for which the interest is paid is effectively connected to that permanent establishment (or fixed base).

In these cases, that interest is taxable in the source country according to its own laws. However, the principles included in article 7 (business profits) or article 14 (independent personal services) must be taken into account.[20]

These rules also apply if the permanent establishment or fixed base no longer exists when the interest is paid but that interest is attributable to the former permanent establishment or fixed base.[21]

Interest Paid by a Permanent Establishment in a Third Country

Sometimes, the interest expense may be borne by a permanent establishment located in a country other than the country where the payor is resident. In these cases, the interest has as its source the country where the permanent establishment or fixed base is located, regardless of the residence of the payor.

For example, if a U.S. corporation lends funds to an Italian permanent establishment of a Swiss corporation, the interest would be treated as having its source in Italy and the treaty would be relevant.

By contrast, for interest derived by a permanent establishment maintained by a recipient in a third country, the availability of a reduced withholding rate is determined under the treaty between the country of the payor and the country of which the recipient is resident and not under the treaty with the country in which the permanent establishment is situated. For example, if a Swiss permanent establishment of an Italian corporation lends funds to a U.S. corporation, the availability of a reduced withholding rate is determined under the treaty, not under the Switzerland-U.S. treaty.

[18]Revenue Reconciliation Act of 1993 amended IRC sections 871(h) and 881(c) to exclude from portfolio interest any interest that is contingent in amount (rather than as to timing or that is payable at a variable rate based on an objective measure). The amendments apply to interest received after 31 December 1993, except for interest on fixed-term debt issued on or before 7 April 1993. *See* IRC section 871(h)(4)(D). *See also* IRC section 2105(b).

[19]*See* OECD commentary on article 11, paragraphs 13 and 14.

[20]*See* article 1, paragraph 10 of the treaty protocol.

[21]*See* the U.S. Treasury explanation of article 11 of the treaty.

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Branch-Level Interest Tax

Under the treaty, in addition to the regular corporate income tax and to the branch profits tax, Italian companies that operate in the U.S. through a branch are subject to a branch-level interest tax. Article 11(8) permits the imposition of that tax on an Italian corporation, but limits its rate to 10 percent.

Main Purpose Test

Article 11 also provides a "main purpose" test similar to that for dividends, royalties, and other income, under which the provisions for interest do not apply if the main purpose, or one of the main purposes, for the creation or assignment of the debt claim for which interest is paid is to take advantage of the interest article of the treaty.

This test was included to help limit transactions that abuse the treaty's provisions. However, the U.S. Senate Foreign Relations Committee placed a reservation on this test citing vagueness as the source of serious concerns about the provision. That means that the U.S. Senate's advice on and consent for the treaty is subject to the reservation on the main purpose test to be included in the instruments of ratification.[22]

According to the U.S. Joint Committee on Taxation (JCT), the provision lacks conformity with other U.S. tax treaties.[23] It would give rise to a subjective test that is difficult to evaluate, that is, dependent on the intent of the taxpayer. Here, the JCT points out that U.S. treaty policy has shifted away from subjective tests.[24]

It is also unclear how the provision will be applied. For example, the Italian tax authorities apparently could apply Italian law to determine whether a U.S. company's main purpose, or one of its main purposes, was to take advantage of article 11. If the U.S. company disagrees with the Italian tax authorities, it could turn to the U.S. competent authority. In any event, it may be difficult for a U.S. company to evaluate whether its transaction may be subject to Italian main purpose standards.

This uncertainty, in the JCT view, can create planning difficulties for legitimate business transactions and can hinder a taxpayer's ability to rely on the treaty.

Finally, and — one might add — more importantly, the JCT noted that many of the types of abusive transactions in which taxpayers would attempt to take advantage of the favorable treaty treatment for interest (and dividends or royalties) involve persons who are not otherwise entitled to treaty benefits. The limitation on benefits provision is designed to address those concerns. Although this provision may not address all of the potential transactions in which a person can improperly take advantage of the treaty benefits, the JCT believes that residual abusive situations could be adequately addressed under U.S. internal law on issues such as beneficial ownership, conduit financing, economic substance, and business purpose and similar abuses, which should apply notwithstanding the treaty. ✦

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[22]In the past, the reservation technique — which critics allege gives the United States a "second look" at treaties negotiated by the executive branch — was infrequently employed by the U.S. Senate in the tax treaty context. Between 1789 and 1991, reservations were lodged to only 18.6 percent of U.S. tax treaties (18 of 97). Furthermore, before the Italy-U.S. Treaty, the reservation process did not appear to have been used in a tax treaty since 1980. *See* Kevin Kennedy, "Conditional Approval of Treaties by the U.S. Senate," 19 *Loy. L.A. Int'l & Comp. L.J.* 89 (1996).

[23]Apparently, the main purpose test is modeled after similar main purpose provisions in treaties of other countries, such as many of the modern treaties of the United Kingdom.

[24]As a matter of fact, the limitation on benefits provision (see article 2 of the treaty protocol) is designed to avoid questions of taxpayer intent by providing a series of objective tests as to whether a person should be treated as a resident entitled to treaty benefits. The technical explanation to article 2 of the treaty protocol acknowledges, in connection with a principal purpose test, that a "fundamental problem presented by this approach is that it is based on the taxpayer's motives in establishing an entity in a particular country, which a tax administrator is normally ill-equipped to identify." As the JCT noted, "although this criticism is specific to a principal purpose test with respect to a treaty shopping provision, the same criticism applies to subjective tests in general."

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