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by Alessandro Adelchi Rossi

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U.S. Revenue Ruling Changes Residency Test for Italian Dual-Resident Corporations

by *Alessandro Adelchi Rossi*

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A ruling recently issued by the U.S. Internal Revenue Service affects the U.S. operations of those Italian corporations that are resident under the laws of both Italy and another country. In Rev. Rul. 2004-76, the IRS addressed the issue of a non-U.S. corporation that is potentially a resident of two foreign countries, each of which is party to a tax treaty with the United States. The IRS held that the rule in the treaty between the two foreign countries would be followed to determine where the corporation is resident, and the U.S. treaty with that country will then govern. The ruling represents a sharp change in the IRS's view on this matter, in line with the U.S. treaty policy. (For the revenue ruling, see *2004 WTD 134-13* or *Doc 2004-14272*.)

The Concept of Dual Residency

Dual residency can occur in different ways. In a treaty context, dual residency can arise when a corporation is incorporated in one country and managed in another. Less frequently, it can occur when an entity is literally incorporated in two countries.[1] For example, a similar situation might arise under the combined laws of Delaware and the Canadian province of Nova Scotia. While Delaware corporate law allows a corporation to "continue" in a non-U.S. jurisdiction without "discontinuing" in Delaware, Nova Scotia corporate law allows a corporation organized under the statute of another jurisdiction to "continue" under the Nova Scotia statute without "discontinuing" under the statute of origination.[2]

Residence of a Corporation Under Italian Domestic Law

For domestic purposes, to determine if a corporation is a resident of Italy, Italian tax law classifies corporations by their physical activities (for example, management, control, and assets) in Italy. Thus, a corporation is considered resident in Italy if its registered office,[3] main activity, or effective place of management is in Italy for 183 days or more during a tax year.[4]

Thus, if a corporation is incorporated in one country and is managed in Italy, that corporation is potentially a resident of both Italy and another country. If, like Italy, the other country is party to a tax treaty with the United States, the dual-resident corporation may qualify under two U.S. treaties.

Residence of a Corporation Under the Italy-United States Tax Treaty

In defining the residence of a corporation, the Italy-United States tax treaty in force[5] looks to the place of incorporation or to the place of management. Unlike it does for individuals, the current treaty does not provide a tiebreaker rule for corporations considered to be residents of both Italy and the United States. Instead, the treaty provides that Italy and the United States can tax their residents without reference to the treaty.[6] Accordingly, dual-resident corporations are permissible under the current treaty.

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[1]In the United States, Rev. Rul. 88-25 treats a similar event as an inbound reorganization. Although the ruling under review would not apply to those facts, presumably it is part of the IRS's response to the issues that can arise from dual residency.

[2]*See* Nathan Boidman, "International Mergers & Acquisitions: A Forum for Discussion," *Tax Notes Int'l*, Apr. 12, 2004, p. 185.

[3]Although for tax purposes Italy applies the test of the registered office, under corporate law the test adopted by Italy is that of the "law of incorporation." Thus, a corporation organized under Italian laws that moves its registered office abroad is still subject to Italian law. *See* art. 25 of *Legge* 218/1995.

[4]*See Testo Unico delle Imposte sui Redditi*, art 73(3).

[5]The current tax treaty and protocol entered into force on Dec. 20, 1985.

[6]*See* article 1(2)(a) of the Italy-United States tax treaty.

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The IRS's Prior Position

Until recently, a foreign dual-resident corporation could choose which U.S. treaty it wanted to use for treaty benefits because in Rev. Rul. 73-564 the U.S. authorities allowed the corporation to choose the treaty that produced the better result. At that time, U.S. tax treaties did not hinge residency determination on whether a corporation was subject to tax as a resident in the foreign country that was a party to a U.S. tax treaty. Accordingly, the following situation might have arisen:

Example: Alpha is a corporation organized under the laws of Switzerland that has its central management and control in Italy. Alpha conducts business in both Switzerland and Italy. Alpha, through its Swiss branch, grants a loan to a borrower located in the United States and receives interest payments from that loan.

Assuming that the corporation in the example above did not have a permanent establishment in the United States, it could have chosen to apply the provisions of either the Italy-United States treaty or the Switzerland-United States treaty to the interest received from U.S. sources because it qualified for treatment under the income tax conventions the United States had with both countries.

Although the Italian treaty imposes a 15 percent withholding rate, the Swiss treaty generally exempts interest payments from U.S. tax.[7] Accordingly, for U.S. tax purposes, the dual-resident corporation in the example would be better off using the Switzerland-United States tax treaty, provided that the limitation on benefits provision is satisfied.

The IRS's Current View

Under the U.S. tax treaties that were applicable when Rev. Rul. 73-564 was issued, the determination of whether a corporation was a resident did not depend on whether the corporation was liable to tax in that country. Conversely, the more recent treaty policy is to provide treaty benefits depending on whether the foreign corporation is treated as a resident of the foreign country for the tax purposes of the two foreign countries.

With the intent, presumably, to be consistent with this policy, on July 12, 2004, the IRS issued Rev. Rul. 2004-76. In this ruling the IRS held that where the treaty between two foreign countries allocates residency of a corporation to one of those foreign countries, then only the U.S. tax treaty with that country would apply to the foreign corporation.

In light of the foregoing, in the preceding example one should look at the relevant article of the Italy-Switzerland tax treaty to determine which country has tax jurisdiction over corporation Alpha. Article 4(3) of that treaty states that if the taxpayer is resident in both countries under the respective domestic laws, it will be deemed resident only in the country where its effective management is located. Thus, under Rev. Rul. 2004-76, Alpha will be treated as a resident of Italy and can only claim the benefits under the Italy-United States treaty. ✦

[7] *See* article 11(1) of the Switzerland-United States tax treaty, which entered into force on December 19, 1997.

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