taxanalysts
Respectfully disagreeable since 1970.

tax notes international

Volume 39, Number 9 ■ August 29, 2005

# News Analysis: Where Is the Italian Treaty?

by Lee A. Sheppard and Alessandro Adelchi Rossi

Reprinted from *Tax Notes Int'l*, August 29, 2005, p. 791

(C) Tax Analysts 2005. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

**Reprinted from *Tax Notes Int'l*, August 29, 2005, p. 791**

(C) Tax Analysts 2005. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

# News Analysis: Where Is the Italian Treaty?

## *by Lee A. Sheppard and Alessandro Adelchi Rossi*

Summer vacation is over and Serie A is starting. Genoa, a promoted team that was found to have fixed a match to get out of Serie B, was booted out, and Torino, another promoted team whose accounts were found to be tainted by fraud, was also denied entry. Given these problems, it's a wonder the competition is starting on time.

Nonetheless, it's going to be a black-and-blue season. Not because of physical play, to use the English euphemism for rough tackles. It's going to be Internazionale's year to win the scudetto.

It was always the case that Inter were a fabulous team on paper, but somehow didn't perform up to their pedigree. How could a team with the brilliant Javier Zanetti, one of several Argentine national team members, and the lethal Adriano, who may well replace Ronaldo on the Brazilian national team, be anything but great?

The nagging inconsistency of last season disappeared in the Coppa Italia, when a disciplined and motivated team rolled over hapless A.S. Roma to win impressively. The nerazzurri's newfound inspiration was confirmed in the recent Super Coppa, the 1-0 scoreline of which does not accurately reflect the Old Lady's dismal performance in the latter half of the match.

No, we're not being sexist. "Old Lady" is the nickname for Juventus, Italy's counterpart to Manchester United — a widely supported team that often wins the domestic league, sometimes aided by bad calls from what Italians refer to as referees in black-and-white underpants. The Old Lady's scudetto last season was aided by a couple of identifiable bad calls and a deliberate decision by crosstown rival A.C. Milan to concentrate on the Champions League instead.

Inter's remaining problems? Oddly enough for defensive Italian football, Inter have holes at the back, and have just acquired Luis Figo, who may be a detriment rather than an asset, from Real Madrid. A big obstacle will be A.C. Milan, who have to push for the scudetto this season to placate unhappy fans. Not the least of these unhappy fans is owner Silvio Berlusconi, who tersely told manager Carlo Ancelotti that the rossoneri must win this season. Then there's the little matter of Inter's fans, who sabotaged their team's chances in the Champions League last season by trying to burn down the San Siro.

Regardless of what happens in Serie A this season, Internazionale may find a place in the sun before the pending Italy-U.S. tax treaty, now celebrating its sixth birthday, sees the light of day. In this article we look at what became of the treaty and whether it matters. (For the 1999 Italy-U.S. tax treaty, see *1999 WTD 202-31* or *Doc 1999-33613*.)

The pending Italy-U.S. treaty, signed on August 25, 1999, but not yet ratified, generally follows the OECD model and other recent U.S. treaties with developed countries. At the time of its proposal, the pending treaty was of great importance to American and Italian businesses. The pending treaty and protocol with Italy would replace the existing treaty, which was signed in 1984. (For the 1984 treaty and notes, see *91 TNI 27-70* and *93 TNI 95-20*.)

Today, after six years, the 1999 Italy-U.S. treaty is still pending. It is unclear where the authorities stand on the ratification process and whether this impasse will be resolved anytime soon. Meanwhile, the U.S. treaty with Slovenia, which was negotiated at the same time and subject to the same reservation as the Italian treaty, entered into force on June 22,

(C) Tax Analysts 2005. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

2001. (Slovenia, coincidentally, is one of the banana peels in Italy's World Cup qualifying group.)

Among several other changes, the pending treaty would allow a foreign tax credit for the Italian IRAP tax, lower the withholding rates on passive investment income, and exempt certain interest and royalty payments from source-country taxation. The pending treaty would end the exemption from U.S. branch tax currently enjoyed by U.S. branches of Italian corporations. It would add an arbitration provision, which Italy wanted. The Americans agreed to arbitration on the condition that it take effect only upon the future exchange of diplomatic notes. The point of the delay was for the United States to gain more experience with arbitration under the German treaty.

## Main Purpose

Our readers know that American treaties have two sets of antiabuse provisions. There are the short and sweet base erosion provisions that do the job, which are usually imposed on what are euphemistically called developing countries. And then there are the long-winded pretend limitation provisions, usually contained in treaties with important trading partners, which let in anyone the treaty partner wants to be allowed in. (For discussion, see *Tax Notes Int'l*, Nov. 1, 2004, p. 387.)

***Internazionale may find a place in the sun before the pending Italy-U.S. tax treaty, now celebrating its sixth birthday, sees the light of day.***

The pending Italian treaty contains the trading-partner version, that is, the ineffectual version, of the American limitations on benefits clause based on the 1996 model treaty. Companies resident in the United States or Italy can qualify for treaty benefits if they satisfy the publicly traded test, the ownership and base erosion test, or the active trade or business test. The base erosion test is the one that really limits benefits. The publicly traded test merely asks that the company or its affiliate be publicly traded on a U.S. or Italian exchange. The active business test merely requires that a whole 10 percent of the company's assets or income relate to an active business. Barring all that, mutual agreement can let a company in. (For discussion, see *Tax Notes Int'l,* Sept. 6, 1999, p 877.)

The Italians wanted more. They wanted to deny treaty benefits sometimes, which the limitation on benefits clause would not do. Italy was interested in including a provision that could be used to deny treaty benefits in the case of abusive transactions like the simplest conduit cases that the U.S. addresses under IRC section 7701(l). (See, e.g., *Northern Indiana Public Service Co. v. Commissioner*, 115 F.3d 506 (7th Cir. 1997).)

Essentially the Italian negotiators were asking for mutual administrative discretion to deny treaty benefits in abusive cases. The government has this power in Italy's other treaties.

At the time of negotiation of the pending treaty, Italy's domestic antiabuse rules were not as effective as the American ones. As a result, prior to renegotiating the U.S. treaty, Italy had incorporated very broad antiabuse provisions in other treaties. For example, under article 30 of the 1995 treaty with Israel "the competent authorities of the Contracting States, upon their mutual agreement, may deny the benefits" of that treaty "to any person, or with respect to any transaction, if in their opinion the receipt of those benefits, under the circumstances, would constitute an abuse of the Convention according to its purposes."

The Americans blanched at this level of discretion. American negotiators considered the Israel-Italy treaty rule, but compromised on the main purpose provisions instead. In the view of the American negotiators, the main purpose test provided a more certain standard against which a taxpayer could meaningfully evaluate its transaction. Can't have a treaty that entirely prohibits tax planning, now can we?

So the pending treaty contains main purpose provisions in addition to limitation on benefits provisions. The main purpose rules would apply to the Dividends, Interest, Royalties, and Other Income articles. Under the main purpose provisions, a person otherwise entitled to treaty benefits will be denied those benefits if the main purpose, or one of the main purposes, of the creation or assignment of the rights giving rise to these items of income is to take advantage of the pending treaty. The main purpose rules are supposed to complement the limitation on benefits provisions.

Appearing at the end of each of the aforementioned articles in the pending treaty, the main purpose clause states:

> The provisions of this Article shall not apply if it was the main purpose or one of the main purposes of any person concerned with the creation or assignment of the rights in respect of which the royalties are paid to take advantage of this Article by means of that creation or assignment.

In the U.S. Treasury's view the main purpose standard corresponds to the principal purpose standard that is applied in a number of U.S. statutory provisions and regulations. In addition, the U.S.

Treasury argued it would be easier for the competent authorities to reach a common understanding on the application of the main purpose standard, which is explicitly included in the pending treaty, than it would be to reach an agreement on the application of an antiabuse provision of one country's domestic law. (For the Treasury explanation, see *1999 WTD 211-22* or *Doc 1999-34700*.)

According to the U.S. Treasury, the domestic business purpose, sham transaction, and substance-over-form doctrines have not been working adequately to prevent treaty abuses either, as they focus on whether, in addition to the abusive purpose, the transaction at issue contains any nonabusive purpose. (For discussion, see *Tax Notes Int'l*, Nov. 8, 1999, p. 1767.)

What sort of transaction are we talking about? There's dividend washing, identified in the Treasury explanation. (See *1999 WTD 211-22* or *Doc 1999-34700*.) An Italian bank would sell its entitlement to a reduced withholding rate on U.S.-source dividends to a third-country customer by buying the shares before the record date, then entering into a repo agreement with the customer, under which it agreed to resell the shares to the customer ex-dividend. This repo contract would protect the bank from market risk during the period when it held the shares and collected the dividend. American readers will recognize the similarity of this transaction to *Compaq Computer Corp. v. Commissioner*, 277 F.3d 778 (5th Cir. 2001), *2002 TNT 1-5* or *Doc 2002-184*.

The staff of the U.S. Joint Committee on Taxation told the Senate the main purpose provision would create considerable uncertainty for taxpayers in the application of otherwise available provisions of the treaties, as they would give rise to a subjective test that is difficult to evaluate. "Such tests inject considerable uncertainty into the treaty provisions because such tests are subjective and vague. This uncertainty can create difficulties for legitimate business transactions, and can hinder a taxpayer's ability to rely on the treaty," the staff huffed in Senate testimony. (See *1999 WTD 214-38* or *Doc 1999-34703*.)

The JCT staff noted that American treaty policy had shifted away from subjective tests, as shown by the series of objective tests contained in the new, long-winded, ineffectual limitation on benefits provision in the Treasury model. (See *1999 WTD 201-19* or *Doc 1999-33584*.)

The U.S. Senate Foreign Relations Committee didn't quite see it Italy's way. Although the Treasury expected the U.S. to incorporate the main purpose provisions into its model, the Senate remained uninformed of the implementation of this policy and was displeased with the lack of consultation on this change in treaty policy. The committee placed a reservation on the main purpose test, citing vagueness as the source of serious concerns about the provision. The reservation has the effect of striking the objectionable provision from the instrument of ratification. (See *Tax Notes Int'l*, Nov. 29, 1999, p. 2075.)

Informal conversations with a representative of the Italian Treasury who was actively involved in the renegotiation of the U.S. treaty revealed that Italian tax authorities have long accepted the Senate's reservations. But they have demanded that these reservations be incorporated into the text of the pending treaty, either directly or by means of a separate document that would be an integral part of the treaty. So the Italian tax authorities passed the ball to the Ministero degli Affari Esteri (the U.S. Department of State's counterpart in Italy) to address the issue with the U.S. authorities at a diplomatic level.

This has had the effect of burying the problem in the Italian bureaucracy, to the extent that the Americans don't know what is happening on the Italian end. The official Treasury line is that American negotiators continue to communicate with treaty partners.

## IRAP

One of the Italian taxes the pending treaty was designed to accommodate, the imposta regionale sulle attivita produttive (IRAP), is before the European Court of Justice, whose advocate general has recommended that it be invalidated as a turnover tax that violates article 33(1) of the Sixth VAT Directive.

IRAP is a regional subtraction-method production tax imposed on a very broad base at a relatively low 4.25 basic rate. IRAP is levied on persons who regularly carry on an activity with the objective of producing or trading in goods or providing services. Governments and nonresidents with permanent establishments are taxable, while some investment and pension funds are exempt. The tax base of IRAP is basically the difference between total proceeds from the activity (excluding portfolio income and extraordinary gains) and production costs. Salaries, reserves, and financing costs are nondeductible. IRAP does not apply when production costs exceed gross intake. For governments and tax-exempt organizations, the tax base is essentially payroll.

The point of the Sixth VAT Directive is to get everyone singing from the same songbook. VAT administrative rules are supposed to be the same for all EU members, even though the rates and bases of national VATs differ. Article 33(1) specifically permits member countries to maintain other taxes, but not turnover taxes. The objective is to prevent member countries from interfering with VAT by adopting



(C) Tax Analysts 2005. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

(C) Tax Analysts 2005. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

competing VAT-like taxes. The theory is that the internal market would be deleteriously affected by VAT-like taxes with different rules.

Well, what's a VAT-like turnover tax? That would be a tax applicable to transactions in goods or services, proportional to the price of those goods or services, charged at each stage of the production and distribution process, and having as its base the value added to those goods or services.

> ***Essentially the Italian negotiators were asking for mutual administrative discretion to deny treaty benefits in abusive cases. The government has this power in Italy's other treaties.***

IRAP fills this bill of particulars, according to ECJ Advocate General Francis Jacobs, opining in *Banca Popolare di Cremona v. Agenzia Entrate Ufficio Cremona*, C-475/03 (Mar. 17, 2005). The Italian government quibbled that IRAP applies to wealth created but not to transactions, so that it is a direct, not indirect, tax. Irrelevant, sniffed the advocate general, since the burden of IRAP may be passed on to the consumer. (See *2005 WTD 52-12* or *Doc 2005-5554*.)

A bit more serious was the Italian government's argument that the European Commission provisionally gave IRAP the green light when it was being enacted in 1997, and has not questioned it since. The government argued that invalidation of IRAP would have catastrophic effects on regional funding, since Italy's regions have come to depend on it. Hence the advocate general recommended that IRAP be invalidated prospectively.

Back in the day when IRAP was perceived to be kosher, the Italians worried about whether it was eligible for the U.S. foreign tax credit. The concern was that because wages and interest expense are nondeductible, IRAP would not be a tax on net income as required by reg. section 1.901-2(b)(4)(i) and Rev. Rul. 73-106, 1973-1 C.B. 343. The idea is that a net income tax is not susceptible of being passed on to others, like customers. (For discussion, see *Tax Notes Int'l*, Dec. 1, 1997, p. 1793; *Tax Notes Int'l*, Nov. 22, 1999, p. 2015; and *Tax Notes Int'l*, Nov. 4, 2002, p. 487.)

Indeed, that IRAP is not a net income tax was the American negotiators' argument. The pending treaty would allow only partial foreign tax credit for IRAP, duplicating an agreement made between the countries a year earlier. To calculate the creditable amount of IRAP, wages and interest would have to be subtracted from the base. (For coverage, see *1999 WTD 165-1* or *Doc 1999-27992*.) This provision will merely become obsolete when Italy eventually repeals IRAP and replaces it with something less like a VAT. The Italian government has just said that IRAP will be gradually phased out between 2006 to 2008. (*2005 WTD 115-1* or *Doc 2005-13019*.)

## Out of Date?

Regardless of the U.S. Senate's reservation on main purpose, the pending treaty may well be outdated. The main purpose test can now be seen as antecedent to the increasingly lengthy, complicated, and bizarrely ineffectual limitations on benefits provisions found in the new U.K.-U.S. Treaty and in the new protocol to the Netherlands-U.S. treaty.

Italian tax law has changed considerably in the past few years. The impending demise of IRAP is only one of the changes. Concepts previously unknown to the Italian system, like the consolidated taxation of groups, thin capitalization, participation exemption, and hybrid entities, have become part of Italian law. This is part of an effort to make Italian law look more like that of other EU members, with which the United States has treaties. (For coverage, see *Tax Notes Int'l*, Dec. 22, 2003, p. 1105; *Tax Notes Int'l*, Jan. 12, 2004, p. 181; and *Tax Notes Int'l*, Aug. 2, 2004, p. 467.)

Does the pending treaty need to be changed to accommodate the changes in Italian law? For the most part, probably not. The OECD model, on which the pending treaty is based, is sufficiently vague that it can handle — however clumsily — a lot of variations in domestic law.

Italy's problem is that it doesn't have its own model treaty. Each treaty is *sui generis*. Treaties are based not just on the OECD model, but on the outdated 1963 OECD model at that. As shown by the recent case of *Ministry of Finance (Tax Office) v. Philip Morris (GmbH), Corte Suprema di Cassazione*, No. 7682/02 (May 25, 2002), and the resulting slap by the OECD, reliance on the OECD model has not done Italy much good. (For discussion, see *Tax Notes Int'l*, Mar. 28, 2005, p. 1127.)

The pending treaty appears to have predated the 1999 American campaign to foist recognition of hybrid entities upon the world. So under the standard residence clause in the pending treaty, residents include partnerships and trusts only to the extent their income is taxable in the state of claimed residence, either in the hands of the partnership/trust or its partners/beneficiaries. (For the Italian check-the-box rules, see *Tax Notes Int'l*, July 25, 2005, p. 329 .)

This standard residence clause is not enough to ensure that the hybrid's income is taxed somewhere. The newer language follows the income item, while the standard version looks at the hybrid. So in the

(C) Tax Analysts 2005. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

2001 U.K.-U.S. treaty, the hybrid question is handled specifically in paragraph 8 of article 1 (not the residence article).

Thus:

> An item of income, profit or gain derived through a person that is fiscally transparent under the laws of either Contracting State shall be considered to be derived by a resident of a Contracting State to the extent that the item is treated for the purposes of the taxation law of such Contracting State as the income, profit or gain of a resident. (*2001 WTD 143-14*, *Doc 2001-20046*.)

Prior to 2004, Italy did not have combined filing. Italy's worldwide and domestic consolidation regimes are not compatible with each other, though a group can elect to use both at once. Worldwide consolidation is only available to Italian-parented companies whose shares are traded on an Italian exchange.

Once elected, worldwide consolidation must be maintained for five years. The ownership requirement is more than 50 percent of voting power of common shares or profits, held directly or indirectly. When worldwide consolidation is elected, all controlled foreign entities must be included, but not all domestic ones. Foreign members need not be corporations or separate legal persons as long as the control requirement is met; inclusion is required regardless of form of organization. Income inclusion in worldwide consolidation is proportionate to ownership.

Like the British treaty, the pending treaty has a pretty standard OECD model double taxation article. The U.S. model treaty has no special language to accommodate worldwide consolidation regimes, since the United States does not have one, and so few other countries do. Additional double taxation language may not be necessary, however, to accommodate Italy's new law. But as the standard OECD model associated enterprises article, which is included in the pending treaty, shows, the OECD model generally does not contemplate taxation of groups as a single taxpayer. The associated enterprise article addresses separate-company taxation of affiliated companies. This has to change across the board, and not just in the pending treaty.

Under the Italian participation exemption, which came into effect in 2004, gains on sales of subsidiary shares by holding companies are exempt from tax, provided the subsidiary carries on a business and is not resident in a blacklisted country, and the holding period is at least a year. There is no minimum ownership requirement. Interest paid to carry these shareholdings is generally nondeductible. Losses on shareholdings are no longer deductible; instead, holding companies can absorb operating losses directly through combined filing. None of this would appear to cause a problem under the gains article of the pending treaty, because it mainly exists to restrain a country from taxing certain gains, not to stop it from granting exemptions.

There is also a 95 percent participation exemption for dividends. For a dividend to be eligible for the participation exemption, Italian law must consider the item to be a dividend. It doesn't matter what the source country thinks it is. Well, what if the United States thinks the deal is a loan and the income item is interest? Italy wouldn't care, and some hybrid securities that allow an interest deduction in the United States would also be entitled to a participation exemption if the payee were an Italian resident eligible for treaty benefits. Around here, we're never entirely sure that the United States objects to this kind of planning.

***Italy's problem is that it doesn't have its own model treaty. Each treaty is sui generis. Treaties are based not just on the OECD model, but on the outdated 1963 OECD model at that.***

Italy adopted a thin capitalization rule as part of the 2004 corporate tax reform. If the company's debt-equity ratio exceeds 4:1, the interest attributable to shareholder loans in excess of that ratio is not deductible. Interest-free shareholder loans may be considered equity, and the relevant shareholder class is owners of 25 percent or more. Nondeductible interest is recharacterized as dividends, so that it would be eligible for the participation exemption in the hands of shareholder/lenders. Paragraph 7 of article 11, a standard provision, adequately addresses the recharacterization question:

> Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the interest, having regard to the debt-claim for which it is paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments is taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.

Prior to 2004, Italian domestic law had no statutory definition of permanent establishment. The new Italian rule is largely based on article 5 of the OECD model. The OECD intends that the positive

list in paragraph 2 of that article is only a suggestion, a minimum threshold. Italian law says the items on the positive list are *a priori* permanent establishments. To the extent the United States disagrees, the treaty or a side note would need to address this question.

There are obvious inconsistencies. On the contentious issue of agency permanent establishment — the *Philip Morris* issue — Italian law does not allow the entirety of the negative list of paragraph 4 of article 5 of the OECD model to absolve the agent of permanent establishment status. Again, the pending treaty would need to be changed to the extent the United States disagrees with this interpretation.

But Italian law does now permit taxpayers to combine exemptions on the negative list and still not have a permanent establishment — a reversal of long-standing practice. The pending treaty would need to be amended to take account of this new position. (For discussion, see *Tax Notes Int'l*, Apr. 26, 2004, p. 357.) Back in 1999, Italy refused to agree to a provision in the U.S. model that said that a taxpayer could combine exemptions on the negative list without having a permanent establishment. (See *1999 WTD 211-22* or *Doc 1999-34700*.)

The recently adopted definition differs from the pending treaty definition on the duration of a construction site. The pending treaty, like the OECD model, considers a building site that exists for more than 12 months to be a permanent establishment. Italian law considers a building site to be a permanent establishment if it lasts more than a mere three months. Unless it is changed, therefore, the treaty would prevent Italy from taxing a three-month-old construction site as a permanent establishment.

In addition, IRPEG, the old Italian corporate income tax, has been replaced by the Imposta sul Reddito delle Società, or IRES. IRES is not so different from IRPEG that the pending treaty would need to be technically changed to accommodate it, though it might be nice to change the reference to IRES.

In light of all this, a ratification of the pending treaty could result in the sort of treaty overrides for which the United States is infamous. But this time it could be Italy, rather than the United States, which does not perform on the treaty in good faith under *pacta sunt servanda*. After all, in what is a remarkable similarity between imperial Rome and the American empire, it was the Roman Senate that was the first known government to breach its tax treaties — in this case, commitments that granted tax immunity to cities in ancient Greece. That was two thousand years ago.

One wonders whether negotiation and drafting of a brand new treaty might not be more practical than the ratification of the one signed in 1999. In this case, however, it might be advisable for the U.S. Treasury to clue the Senate Foreign Relations Committee in on the negotiation process. ◆

♦ *Lee A. Sheppard is a contributing editor to Tax Notes International. E-mail: lees@tax.org*
*Alessandro Adelchi Rossi is with Funaro & Co., P.C. in New York.*

(C) Tax Analysts 2005. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.