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ITALY

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Italy - new guidelines on outbound dividend withholding tax

Overview

On July 8th, 2011, the Italian tax authorities, with the issuance of guideline n.32/e, clarified that the 27% Italian withholding tax rate does not apply to dividends distributed to certain qualifying corporations that are resident in an EU member state, Norway or Iceland, regardless of the earnings (post-2007 or pre-2008) from which the dividends are paid.

In place of the 27% rate, either a 1.375% or a 1.65% rate will apply, depending on whether the dividend is paid from post-2007 earnings or from pre-2008 earnings.

The clarification applies to both future dividend distributions of pre-2008 earnings and distributions since January 1, 2004. Qualifying corporations may therefore claim a refund for Italian tax levied on any excess. The taxpayer must claim the refund within 48 months of the tax withholding date.

With this clarification, the Italian tax authorities established the requirements for claiming the reduced withholding taxes.

Background

On November 19th, 2011, the European Court of Justice ("ECJ"), in decision C-540/07, held that the Italian 27% withholding tax rate on dividends paid to corporations established in other European member states was contrary to the non-discrimination principle and therefore in breach of the freedom of capital movement in Article 56.1 of the European Community Treaty (now Article 63.1 of the Treaty on the Functioning of the European Union). Indeed, the same dividends received by Italian resident corporations are subject to a significantly lower tax burden (i.e., 1.65% through December 31, 2007, 1.375% effective January 1, 2008).

Strictly speaking, the ECJ decided that the same dividend tax treatment applied to Italian resident corporations must also be granted to corporations resident in other EU member states. It also specified that the same treatment must be granted for all dividend distributions since 2004, i.e, the year in which the dividend exemption regime replaced the tax credit mechanism in Italy.

In the meantime, Italy introduced a 1.375% withholding tax for dividends paid to certain qualifying corporations that were resident in an EU member state or Norway. However, this reduced rate was applicable only to dividends paid from post-2007 earnings, while the dividends paid from pre-2008 earnings were still subject to a 27% withholding tax. Furthermore, the reduced 1.375% rate was not extended to Iceland.

The extension of the reduced rate to dividends from pre-2008 earnings - combined with the clarification that the reduced rates apply also to Iceland - fully applies the ECJ's decision. Perhaps the Italian Parliament will adopt this extension through legislation since the guidance released is only binding on the Italian tax authorities.

The current situation

In light of the Italian tax authorities' clarification, the Italian outbound dividend withholding taxes are as follows.

1. Under Italian domestic law, outbound dividends are generally subject to a final withholding tax of 27% (potentially reduced to 15% if the taxpayer can demonstrate that it paid tax on the same dividends in the recipient's country of residence), with the exceptions reported below.
2. Dividends on savings shares ("*azioni di risparmio*") are subject to a 12.5% withholding tax.
3. A reduced rate of 1.375% applies to dividends paid out of post-2007 earnings to companies or entities (i) subject to corporate income tax and (ii) resident in an EU or EEA (European Economic Area) country that allows an adequate exchange of information with the Italian tax authorities (basically, the EU member states, Norway and Iceland). The rate increases to 1.65% for the dividends paid out of pre-2008 earnings.
4. Under the EU Parent-Subsidiary directive, no withholding tax applies on dividend payments to qualified European parent companies, providing the following conditions are met:
    1. The parent company is an EU country resident and takes one of the forms listed in the Directive.
    2. The parent company is an EU country resident for tax purposes and, under the terms of an income tax treaty concluded with a third state, is not considered resident outside the EU.
    3. The parent company is subject to one of the taxes listed in the directive without the possibility of exemption.
    4. A 10% interest in the company's capital must be held for 12 months.
    5. If the ultimate parent is a non-European company, the exemption applies only if the company can prove that the shares are not held exclusively or mainly for the purpose of avoiding the withholding tax.

The refund claim and economic substance

The Italian tax authorities clarified that the refund claims can be submitted only with regard to the dividends that benefitted from the 95% exemption regime (effective January 1, 2004) and that were distributed to qualifying corporations.

To qualify, the corporations must, *inter alia*, (i) be liable to tax in their state of residence and (ii) demonstrate they were subject to a tax treatment worse than the treatment received by Italian corporations for the same dividends. In computing their final tax burden, therefore, the foreign corporations must consider the favorable impact of any foreign tax credit provided by their home tax system with reference to the Italian withholding tax levied.

In addition, the previously mentioned 48-month deadline must not have expired.

Importantly, the Italian tax authorities stated that the refund must not be granted to qualifying corporations that are part of a mere "artificial arrangement," i.e., an abusive scheme mainly aimed at obtaining undue tax advantages.

Thus, according to the Italian tax authorities, even in the absence of a specific anti-avoidance provision, the tax authorities may use the judicially developed "abuse of law" principle to dispute the application of the reduced withholding taxes, even though they must prove the existence of a purely artificial arrangement. The Italian tax authorities might pursue this approach not only with respect to any refund claims, but also in reviewing the correct application of the reduced rates carried out by the Italian corporations in their roles as withholding agents.

According to the tax authorities, in order for an artificial arrangement to exist, taxpayers must use either:

- a conduit entity, i.e., an entity merely interposed, or
- a conduit transaction.

The first situation might occur when the corporation owning the participation in the Italian entity does not carry on an actual business activity with proper substance in the country of incorporation.

The second situation requires a step-transaction, where the participation in the Italian corporation, owned by a corporation not eligible for the reduced rates, is first bought by an entity formally entitled to benefit from the reduced rate, and then, after the dividend distribution, is sold back to the original owner with a view to transferring the manufactured dividend to the original owner.

The Italian tax authorities will interpret the abuse of law concept in the light of the Commission of the European Communities' (the "Commission's") guidance, which is based on the ECJ cases.

In the Com (2007) 785 , the European Commission highlighted that the ECJ *"... has held ... that the mere fact that a subsidiary is established in another member state ("MS") cannot, of itself, be treated as giving rise to tax avoidance and that the fact the activities carried out by a secondary establishment in another MS could just well be pursued by the taxpayer from within the territory of its home MS does not warrant the conclusion that there is a wholly artificial arrangement. The ECJ has also expressly confirmed that it is quite legitimate for tax considerations to play a role in the decision on where to establish a subsidiary. The objective of minimising one's tax burden is in itself a valid commercial consideration as long as the arrangement entered into with a view to achieving it do not amount to artificial transfers of profits. In so far as taxpayers have not entered into abusive practices, MSs cannot hinder the exercise of the rights of freedom of movement simply because of lower level of taxation in other MSs. This is the case even in respect of special favourable regimes in the other MSs' tax system ...ECJ held that an establishment is to be regarded as genuine where, based on ... evidence of physical existence in terms of premises, staff and equipment, it reflects economic reality...The ECJ confirmed that the fact that the terms and conditions of financial transactions between related companies resident in different MSs deviate from those that would have been agreed upon between unrelated parties constitutes an objective and independently verifiable element for the purpose of determining whether the transaction in* *question represents, in whole or in part, a purely artificial arrangement.*" In Resolution 10597/10, the Council of the European Union provided a list of indicators that suggest the artificial diversion of profits to a controlled foreign company in the context of wholly artificial arrangements. Some of them are reported here below.

a. There are insufficiently valid economic or commercial reasons for the profit attribution, which therefore does not reflect economic reality.
b. Incorporation does not essentially correspond with an actual establishment intended to carry on genuine economic activities.
c. There is no proportionate correlation between the activities apparently carried on by the CFC and the extent to which it physically exists in terms of premises, staff and equipment.
d. The taxpayer has entered into arrangements which are devoid of economic reality; serve little or no business purpose or which may be contrary to general business interests, if not entered into for the purpose of avoiding tax.

In light of the above, the Italian tax authorities indicated that:

- They will carefully determine whether holding companies are part of artificial arrangements, since they ordinarily neither have nor are supposed to have a "*significant physical presence*".

- A corporation that simply holds participations, benefits from a tax regime in its country of establishment that is more favorable than the Italian tax regime, does not carry on business activities other than the mere detention of the participations, and whose shareholdings reveal that Italy is the exclusive or prevalent center of its interests, shall be considered as a mere artificial arrangement for the purpose of applying the reduced withholding tax rate.

- Conversely, holding companies that actually carry on oversight and coordinating activities over their subsidiaries and provide centralized services to them are entitled to benefit from the reduced rates.

Finally, note that the above comment on the substance requirement is only binding on the Italian tax authorities. Accordingly, case-law may deviate from the Italian tax authorities' position.

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