Executive summary

On 16 September 2016, the Italian Tax Authorities issued a regulation (the Regulation) providing further clarifications on the white list controlled foreign company (CFC) legislation. The scope of the CFC rules also includes companies located in a jurisdiction which is not considered to have a privileged tax regime, provided that both of the following conditions are met:

- The actual income tax paid in the foreign jurisdiction is lower than 50% of the Italian corporate income tax that would be applicable to the company if it was resident in Italy.
- More than 50% of the proceeds of the foreign subsidiary consists of passive income for CFC purposes.

With specific reference to the first condition, the Regulation provides for simplified rules to calculate the effective foreign tax of a CFC and the related virtual domestic tax.

Detailed discussion

The Regulation, issued pursuant to the provisions set forth by Legislative Decree no. 147/2015 (Internationalization Decree), and following previous clarifications of the Italian Tax Authorities, introduces a simplified methodology
to determine the conditions triggering the CFC rules applicable to entities resident in white listed jurisdictions (i.e., European Union (EU) and non-EU countries providing an adequate exchange of information).

Such regime is subject to the joint verification of the following two conditions:

- The actual income tax paid in the foreign jurisdiction is lower than 50% of the Italian corporate income tax that would be applicable to the company if it was resident in Italy.
- More than 50% of the proceeds of the foreign subsidiary consist of passive income for CFC purposes.

In order to apply the above provisions the Regulation clarifies that a comparison between the following shall be carried out:

- The Foreign Effective Tax Rate (FETR), defined as the ratio between the foreign taxes paid by the CFC and the Profit Before Tax (PBT) booked in the CFC’s profit and loss register (P&L)
- The Virtual Domestic Tax Rate (VDTR), defined as the ratio between the taxes that the CFC would have paid in Italy, as calculated on the taxable basis determined under the current Italian corporate income tax (CIT) rules, and the PBT booked in the CFC’s P&L

The Regulation further provides criteria and methodologies in order to better identify the elements necessary to determine both the FETR and the VDTR.

With regard to the FETR, it is set forth that:

- The taxes covered are only the income tax due in the State of the CFC, gross of any foreign tax credit (FTC) attributable to the CFC
- If a treaty is in force with the State of the CFC, the income taxes to be considered are those provided under the treaty
- In case of a Federation or Confederation of States, State and Municipal taxes also have to be considered (even if not expressly included in a treaty)

As the VDTR is concerned, the Italian taxes to be considered are only CIT (IRES) and its surcharges (Italian Regional Tax is excluded), gross of any FTC related to income sourced in other foreign countries (i.e., different from the CFC’s country).

Besides the above, the Regulation provides operational criteria to determine both the FETR and the VDTR. From an accounting perspective, for the computation of the VDTR reference should be made to the CFC’s books, as prepared according to the accounting principles applicable in the State of the CFC. Specific provisions apply if the CFC has adopted International Accounting Standards/International Financial Reporting Standards principles.

With reference to the tax rules necessary to quantify the above mentioned tax rates, the following elements shall be considered:

- Income taxes effectively due by the CFC as shown in the CFC’s financial statements and in the documentation related to tax returns, tax payment forms, withholding taxes (WHTs) withheld
- In the case of a group taxation regime, only the taxes due by the CFC on a stand-alone basis
- The tax deductions related to the Italian Notional Interest Deduction Regime (ACE), as well as similar provisions applicable in the State of the CFC

On the contrary, and for simplification purposes, the following elements are disregarded from the tax computations:

- Timing tax adjustments (e.g., depreciation deductions)
- Optional tax regimes that would have been adopted by the CFC if it have been tax resident in Italy
- For both FETR and VDTR computations, the ordinary 80% cap applicable to Italian net operating losses, as well as the equivalent provisions applicable in the State of the CFC
- Any foreign tax incentive having an exceptional nature, granted to the generality of the taxpayers for a period not exceeding five fiscal years. The exception to such rule is represented by tax attributes presenting a different regime, as well as the measures resulting from agreements reached between the CFC and the foreign tax authorities

It has also been clarified that the Italian Participation Exemption rules (providing for a 95% exemption of capital gains and dividends) are considered as a full exemption regime which provides for a non-deductibility of the costs related to the participation in the CFC’s State.

Endnote
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