Executive summary

On 4 August 2016, the Italian Tax Authorities (ITA) issued Circular n. 35/E (the Circular), providing extensive clarifications on the Italian Controlled Foreign Companies (CFC) regime.

The Circular also summarizes the recent changes to the CFC rules introduced by 2015 and 2016 Budget Laws (Law n. 190/2014\(^1\) and Law n. 208/2015\(^2\)) as well as by Legislative Decree n. 147/2015 (Internationalization Decree\(^3\)).

Among the various issues addressed, particular emphasis is given to the following:

- CFC black list countries and black list income
- Definition of special tax regimes
- Clarifications on the second exemption to avoid CFC rules
- Computation of the CFC income
- Foreign Tax Credit (FTC)
- Procedural aspects
Detailed discussion

CFC black list countries

The black list criteria (to be verified on an annual basis) provided for CFC purposes have been significantly revised between fiscal years (FYs) 2014 and 2016 and may be summarized as follows:

<table>
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<tr>
<th>Black list identification parameters</th>
<th>Until 31/12/2014</th>
<th>From 1/1/2015 until 31/12/2015</th>
<th>From 1/1/2016</th>
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<tr>
<td>Jurisdictions listed in the Ministry Decree of 21/11/2001 (black list) with:</td>
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<td>a) Taxation lower than 30% of the Italian tax rate</td>
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<td>b) Lack of an adequate exchange of information</td>
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<td>c) equivalent criteria</td>
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<td>Jurisdictions listed in the Ministry Decree of 21/11/2001 (black list) (as amended by Ministry Decree of 30/3/2015 and Ministry Decree of 18/11/2015), with:</td>
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<td>a) Taxation lower than 50% of the Italian tax rate</td>
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<td>b) Lack of an adequate exchange of information</td>
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<td>Special tax regimes with:</td>
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<td>a) Taxation lower than 50% of the Italian tax rate; or</td>
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<td>b) Taxation formally higher than 50% of the Italian tax rate but substantially lower by virtue of special privileged tax treatments</td>
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<td>• EU and EEA Countries are excluded</td>
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<td>• Nominal tax rate lower than 50% of the Italian tax rate</td>
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<td>• Special tax regimes (nominal tax rate lower than 50% of the Italian tax rate)</td>
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<td>• EU and EEA Countries are excluded</td>
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As of FY 2016, a black list country for CFC purposes is deemed to exist if the relevant nominal tax rate applied is lower than 50% of the Italian tax rate. In this regard, the foreign applicable income taxes shall be considered, while for Italian tax purposes the nominal tax rate is established by the Corporate Income Tax (IRES) and the Regional Tax on Productive Activities (IRAP). Additional guidance for such comparison might also be sought in the corresponding Double Tax Treaty (treaty) signed with Italy (if any).

The presence of an adequate exchange of information between Italy and the foreign State is therefore no longer necessary in order to assess the presence of a black list jurisdiction, which now shall be identified on a case-by-case analysis.

The Circular also provides criteria on how to apply the different CFC rules depending on the period of reference (i.e., before FY 2015, FY 2015 and after FY 2015 as indicated in the table above). To verify whether the foreign income is derived from a black list country, it is further clarified that the FY in which the income has been collected shall be taken into account by the taxpayer. Detailed instructions are also provided in case the income has been collected and accrued during multiple FYs in order to determine whether the foreign jurisdiction could present a privileged tax regime.

Definition of special tax regimes

A black list jurisdiction for CFC purposes is also deemed to exist if a “special tax regime” (i.e., more favorable tax provisions than the ordinary rules) applies to the foreign subsidiary. The Circular clarifies that such special tax regime:

- Applies to all taxpayers satisfying all the requirements laid down in the local tax rules
- Provides for: (i) a decrease of the applicable tax rate; or (ii) exemptions or other erosions of the taxable basis (including notional interest deduction) which de facto result in a lower tax due
As an example, special tax regimes might arise taking into account the following factors: (i) particular economic activities carried out (e.g., financial, agricultural, tourism); (ii) geographical zones of investment (e.g., free zones); (iii) specific categories of taxpayers (e.g., small and medium enterprises); and (iv) time limitations (e.g., start-up phase), among others.

A special tax regime agreed between the tax authorities through a ruling procedure does not exclude the application of the CFC provisions.

On the contrary, in the event that a foreign subsidiary was located in a State having a nominal tax rate lower than the 50% of the Italian rate, but was subject to a final tax burden higher than the mentioned 50% due to special applicable tax rules, no CFC regulations would apply (i.e., no special tax regime would exist).

In the case of multiple economic activities only partially subject to special tax regimes, CFC rules would be triggered if, under a prevailing criterion, the majority of the revenue generated were covered by the more favorable tax provisions.

Clarifications on the second exemption to avoid CFC rules

CFC rules do not apply if the Italian parent obtains an advance ruling under the following alternative exceptions:

- The foreign company carried out as a main activity an actual industrial or commercial activity in the market of the State or territory in which it was located (first exemption)
- The overseas entity does not constitute an artificial structure aimed at achieving undue tax advantages (second exemption)

The Circular considers that the second exemption might successfully be invoked by the Italian shareholder when any of the following requirements are met:

- A privileged tax regime applies to the foreign entity, but more than 75% of its revenues are generated and fully taxed in a white list country
- A privileged tax regime applies to the foreign subsidiary which is either: (i) resident for tax purposes in a white list country; (ii) has its place of effective management in a white list country; or (iii) carries out its main economic activity in a white list country and the profits generated therein are fully subject to tax

- A white list foreign subsidiary has a permanent establishment located in a black list jurisdiction, but the income attributable to the permanent establishment is fully taxed in the hands of the head office

Besides the conditions set forth above, the lack of any undue tax advantage may be demonstrated if the overseas investment has not generated any significant tax savings. Such condition can be satisfied if the overall tax burden is at least equal to 50% of the taxes which would have been due, had the foreign subsidiary been a tax resident of Italy.

Computation of the CFC income

The Circular points out that the CFC income shall be determined in accordance with the applicable Italian Corporate Income Tax rules (save specific exclusions), which must be adopted irrespective of the nature of entity (e.g., corporation or partnership) or the activity carried out by the latter.

For these purposes, the Circular reaffirms the applicability of special tax provisions such as the “dormant company” regime. Tax incentives generally applicable to resident taxpayers such as the Notional Interest Deduction (NID) regime, may also be included in the computation of the CFC taxable income.

Foreign Tax Credit

If a taxpayer has obtained a positive ruling based on the first exemption contained in the Italian CFC provision (i.e., proper business substance), when dividends are actually paid by the foreign company, the Italian shareholder is subject to full taxation but he is allowed to benefit from an underlying FTC for any taxes paid abroad by the black list subsidiary.

The Circular clarifies that the credit in question is considered as an “indirect” credit, as it is granted for taxes paid by the CFC (i.e., not directly by the Italian shareholder), and falls within the ordinary Italian FTC rules.

As the general FTC rules are concerned, the Internationalization Decree set forth that the right to an FTC is deemed to arise not only with reference to the taxes covered by a treaty between Italy and the foreign State, but also to any other income tax or duty levied on the income generated abroad. In order to seek relief through the FTC, it would therefore be necessary to assess whether the tax levied on the foreign income may be considered as an income tax under the Italian rules.
Procedural Aspects
Pursuant to some changes made by the Internationalization Decree, the ruling procedure to avoid CFC legislation consequences is now no longer mandatory but it remains as an optional procedure. The conditions required for the exemption from the regime can now be proved during the tax audit process. Accordingly, tax assessments concerning the CFC regime can’t be issued if the taxpayer has not been given the opportunity to provide evidence of one of the mentioned exemptions within 90 days from the clarification request.

In the absence of a positive ruling (and provided that the flow-through taxation has not been applied), the Italian parent needs to disclose in its tax return the ownership of the shares triggering the application of the CFC rule. Specific penalties, which cannot exceed €50,000, apply for failure of such disclosure.

Endnotes
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**Global Tax Desk Network of Ernst & Young LLP in the United States**

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