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Italy – New CFC guidelines ease pressure on foreign issuing vehicles

Key Issues

New CFC guidelines issued

Foreign issuing SPVs out of the net

Foreign onshore investment funds not CFCs under certain conditions

The Italian tax authorities have just released additional guidelines clarifying several open points on the application of the new, broader, CFC legislation. The guidelines are very welcome as Italian parent companies of foreign affected subsidiaries are currently facing the need to submit their CFC ruling application to the tax authorities.

The main clarification concerns the application of the CFC legislation to companies established in jurisdictions other than tax havens, earning mainly passive income and subject to an effective tax that is less than 50% of the effective tax that they would be bearing had they been residents of Italy for tax purposes. Indeed, as of 2010, CFC legislation also applies to foreign entities controlled by Italian companies and established in any jurisdiction (including EU Member States) if they:

- are subject to a tax that is less than half of the Italian tax that would be applicable to their income had they been resident of Italy for tax purposes (the "**Effective Tax Rate Test**"); and
- derive more than 50% of their proceeds from the management, holding or investment in securities, shareholdings, receivables or other financial assets, the sale or licensing of intangible rights on industrial, literary or artistic property or the supply of intra-group services, including financial services (the so-called "**Passive Income**").

If the foreign subsidiary meets the above tests, the Italian parent may still avoid the application of the CFC legislation if it demonstrates, through a ruling procedure, that the establishment of the foreign subsidiary does not constitute a "wholly artificial arrangement" (within the meaning of the decision by the European Court of Justice of 12 September 2006, C- 196/04, *Cadbury Schweppes*).

The main clarifications provided by the Italian tax authorities can be summarised as follows:

Foreign funding vehicles

The guidelines contain a much needed clarification in relation to the Effective Tax Rate Test. In particular, one of the main issues surrounding the expansion of the CFC legislation was about the applicability of the domestic rules limiting the deduction of interest expenses on bonds issued by non-listed companies.

When running the Effective Tax Rate Test, the following two rates must be compared:

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- what would have been the actual tax rate applicable to that foreign company had it been resident in Italy for tax purposes (subject to a 27.5% corporation tax) (the "**Theoretical Italian Rate**"); and
- the effective rate actually applied to the foreign subsidiary in its host jurisdiction (the "**Actual Foreign Rate**").

In computing the Theoretical Italian Rate, the taxable profits should be calculated applying Italian tax legislation. The question had arisen as to whether all Italian rules limiting the deduction of interest expenses had to be considered in the case of foreign subsidiaries issuing securities and on-lending to their foreign affiliates, particularly focusing on the rule providing that interest on bonds is not deductible for the amount that exceeds: (i) 200% of the official BCE reference rate (at the time of issue), in the case of bonds listed on a regulated market; or (ii) 166% of the official BCE reference rate (at the time of issue), in the case of bonds not listed on a regulated market.

Applying this provision when determining the Theoretical Italian Rate would have resulted in virtually all foreign funding vehicles falling short of the test and having to go through the ruling procedure to avoid being treated as a CFC, thus creating a significant tax leakage. Because it is expected that the positive rulings would (at least initially) be granted only in the presence of a local substance (i.e. offices and employees) normally lacking in such vehicles, the great uncertainty has forced several Italian groups that use foreign funding vehicles to consider unwinding such vehicles.

The clarification will result in these vehicles, when established in a non-blacklisted jurisdiction (such as EU Member States), not being captured by the new CFC legislation, thus resolving a very significant issue. The issue would survive as to funding vehicles established in Ireland, since, even without distortions in the computation of the taxable basis, the nominal tax rate would still be lower than 50% of the Italian nominal tax rate (currently at 27.5%).

The Circular also addresses the treatment of foreign SPVs established by Italian banking groups to issue hybrid capital securities. The tax authorities have taken the position that, while such SPVs may in principle fall within the scope of application of the new CFC legislation, when addressing the relevant ruling applications the Italian tax authorities will firstly have to determine whether:

- the structure was set up prior to the entry into force of Legislative Decree No. 6 of 17 January 2003;
- the foreign SPV is operating in compliance with the authorisation of the Bank of Italy for the issuance of hybrid securities;
- the unwinding of the structure would be severely detrimental for the Italian banking group;
- the Italian banking group formally commits to unwinding the structure once the hybrid capital securities have been redeemed.

If the above conditions are met, the authorities will accept the ruling application without investigating whether the foreign SPV constitutes a "wholly artificial arrangement".

Foreign investment funds

The CFC legislation will not apply to foreign entities organised as collective investment undertakings, i.e. those entities that:

(a) are owned by several investors;
(b) act following investment policies and regulations subject to the regulatory control by supervisory authorities;
(c) t are managed by professional managers, who act independently from the investors.

The above conditions will be deemed complied with in the case of:

(i) UCITS compliant funds;
(ii) Non-UCITS compliant funds established within the EU or EEA and subject to regulatory supervision;
(iii) collective investment vehicles subject to regulatory supervision and established in a state that allows an adequate exchange of information, as per the white list of states and territories provided in Decree of 4 September 1996.

Miscellaneous

The guidelines also contain several clarifications on the mechanics for the application of the Effective Rate Test – such as the identification of the relevant accounting principles, the treatment of losses, the treatment of reserves and

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provisions – and the application of the CFC legislation to foreign subsidiaries engaged in banking, financial and insurance activities.

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