



# VECO TAX

## News

Periodical review of the latest international tax news published by Verga Group  
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### ITALY

#### *Genuine business activities and CFC rules*

The Italian tax authority has ruled that a Hong Kong company (Beta) engaged in genuine business activities cannot be subject to CFC rules (Ruling No. 128/E of 26 May 2009). In another case (Ruling No. 165/E of 22 June 2009), the tax authority rejected the request to disapply CFC rules for a company located in Hong Kong.

Ruling No. 128/E

#### *The request*

Alfa, the parent company resident in Italy, submitted a request for the CFC rules to be disappplied in relation to a shareholding in Beta, which does business in the jewellery sector.

For the CFC rules to be disappplied, the resident company must demonstrate either that the non-resident company is engaged primarily in genuine industrial or trade activities in the host country, or that the shareholding does not produce revenues located in a tax haven.

Alfa pointed out that Beta used premises and several employees in carrying out its activities. Beta has business relations with three different types of customers, acting at times as a business intermediary, at times as a trader in raw materials and

at times as the designer of the product that is requested, guaranteeing quality control throughout the various phases.

To that end, Beta provided extensive documentation (bills, customs forms, contracts, etc.) to demonstrate its involvement in the creation, design and sale of jewellery, although all manufacturing activities are outsourced to a company in China.

#### *The reply*

The tax authority held that Beta is not a CFC as it fulfils the requirement of carrying on genuine business activities. The authority also pointed out the company's geographical and cultural closeness to its sources of supply and nearness to the Asian markets in which the end products are sold.

Ruling No. 165/E

With this ruling the tax authority held that a company resident in Hong Kong (Alfa) is a CFC as it is not engaged in genuine business activities there.

In this case, Alfa performed business intermediation activities for a company resident in China, through an office and three employees.

The authority ruled that the provisions pursuant to article 167 of the Consolidated Income Tax Law could not be disappplied given the absence of economic, political, geographic

### IN THIS EDITION:

#### ITALY

*Genuine business activities and CFC rules*

1

#### ITALY

*Dividends paid to non-residents*

2

#### IRELAND

*Royalties – New tax regime*

2

#### LUXEMBOURG

*Exchange of information*

3

#### CYPRUS

*New protocols with Russia and Italy*

3

#### ITALY - SWITZERLAND

*Deductibility of expenses for promotional activities by a Swiss company.*

4

or strategic connections with Hong Kong. The decision was taken in the light of the authority's considerations, according to which Alfa's organisational structure did not meet the substance requirements in terms of employees and its suitability to carry on the economic activity in an independent manner. The tax authority also held that, on the basis of the documentation provided, Alfa did not have an independent strategic and decision-making centre in Hong Kong.

## ITALY

### *Dividends paid to non-residents*

The Italian tax authority has issued a commentary on the tax regime applicable to dividends paid by Italian companies to non-residents (Ministerial Circular No. 26/E of 21 May 2009).

#### *Domestic legislation*

According to article 27-ter of Presidential Decree No. 600/1973, amended by the 2008 Finance Act, dividends paid to companies or organisations resident in a member state of the EU or of the EEA (European Economic Area, in actual fact only Norway), are subject to withholding tax levied at the rate of 1.375 percent. Withholding tax is levied at 27 percent in all other cases, unless a lower rate is envisaged under the provisions of a tax treaty. Non-residents may request a reimbursement of the tax paid abroad for up to four ninths of the withholding tax charged in Italy (but only if the withholding tax is levied at the rate of 27 percent).

This law is not applicable to companies that fall within the scope of article 27-bis (Parent-Subsidiary Directive), which

may directly request the subsidiary not to levy the withholding tax envisaged by law.

#### *The 1.375 percent withholding tax*

The 1.375 percent withholding tax is applicable to dividends paid to companies or organisations subject to corporate income tax. It does not apply to individuals and non-resident organisations that are not generally subject to corporate income tax (thus including partnerships, associations and trusts, unless considered "opaque" under the applicable domestic legislation).

In order to qualify for the reduced rate of withholding tax, the beneficiary must be resident in an EU or EEA country included in the list of countries that permit an adequate exchange of information. It must also be subject to income tax in its country of residence or the country in which it has its permanent establishment. In that respect, liability to income tax is interpreted from a general perspective, regardless of whether the taxpayer qualifies for any allowances in line with EU laws. The provision also regards companies that do not pay tax by virtue of objective exemptions associated with the type of income (for example passive income) or the actual place of business.

#### *Procedural issues*

Resident taxpayers can apply the reduced rate of withholding tax directly at the request of non-resident beneficiaries. The request must include proof of the place of residence in the form of a certificate issued by the tax authority of the host country.

#### *Entry into effect*

The new rates apply to dividends payable starting from the financial period following that

at 31 December 2007.

The tax authority has specified that the presumption pursuant to the Ministerial Decree of 2 April 2008, whereby distributed dividends are deemed to be primarily derived from profits of the subsidiary accrued as from the financial period ended at 31 December 2007, does not apply to profits distributed to non-resident companies benefiting from the reduced rate of withholding tax.

## IRELAND

### *Royalties – New tax regime*

The Irish Government's 2009 Finance Bill includes the introduction of a new tax regime applicable to royalties paid to resident companies that own the relative intellectual property rights. Although additional amendments may be tabled, the general outline of the new regime has already been defined and appears to offer some important benefits.

#### *Who is eligible*

Companies that are resident in Ireland will be able to opt for the new regime on expenditure incurred for the acquisition of "qualifying" intangible assets. The Bill includes grandfathering provisions for companies that benefit from existing relief schemes which are no longer compatible with the new law.

#### *Assets that qualify for relief*

The definition of intangible assets that qualify for relief is very broad and includes the acquisition (or exploitation) of patents, registered designs, trade marks, domain names, titles, know-how, licences to sell, formulas and good-will (directly attributable to "qualifying" assets).

#### *Exemption of income arising from intangible assets*

Under the new rules companies will be able to deduct up to 80 percent of income arising from the exploitation of “qualifying” intangible assets. Taking into account the current corporate income tax rate of 12.5 percent, this will result in a net tax rate of 2.5 percent.

Companies will be able to opt for fixed-rate write down, with allowable deductions capped at 80 percent of the taxable income derived from the exploitation of the intangible asset.

The write down period may either follow the standard accounting treatment of the relative asset, or companies can opt for a 15 year fixed write down of 7 percent per annum for the first 14 years and 2 percent in the final year. The allowance will only be available against the taxable income which is derived from exploiting the intellectual property. Any excess of income (royalty receipts) and expenditure (allowances) may be carried forward without any time limit.

#### *Other issues to be considered*

It is interesting to note that Irish companies may opt for this relief while also carrying on other trading activities. However, losses deriving from one activity can only be set off against income derived from the same activity.

There are also specific provisions for the exit phase (capital gains tax).

## **LUXEMBOURG**

### *Exchange of information*

As part of its commitment to meet OECD standards on transparency and exchange of information for tax purposes, Luxembourg has signed

protocols with a number of countries (to date Bahrain, Denmark, France, India, the Netherlands and the USA). The protocols amend the provisions governing the exchange of information under existing double tax treaties.

The new protocol brings the provisions on the exchange of information in line with article 28 of the OECD model treaty.

Luxembourg will start exchanging information on taxpayers with treaty partners, but only upon request. It is worth noting that the provision does not authorise automatic exchange of information or general requests (so-called “fishing expeditions”).

The agreements are expected to be ratified in 2009 and come into force in 2010. The protocols will not be applied retroactively (except for that with the USA, which will be enforced retroactively as from 1 January 2009).

## **CYPRUS**

### *New protocols with Russia and Italy*

On 16 April 2009 the Cypriot and Russian Governments signed a protocol amending the existing tax treaty between the two countries. The protocol should be ratified by the end of 2009 and come into force in 2010.

Furthermore, on 4 June Cyprus and Italy signed a protocol amending their tax treaty and introducing new provisions to foster the exchange of information. The text of the protocol is not yet available, but the provisions are expected to come into force in 2010.

### *Exchange of information between Cyprus and Russia*

The protocol signed by Cyprus and Russia extends the disclosure of information between the two countries to include bank and corporate documentation, but only at the specific request of the competent authorities of the other treaty country.

### *Dividends, interest and royalties*

Under the tax treaty between Cyprus and Russia, dividends paid to non-residents are liable to withholding tax levied at a rate of 10 percent. This is reduced to 5 percent for investments of at least EUR 100,000 (previously USD 100,000). Interest and royalty payments will continue to be exempt from withholding tax.

### *Capital gains*

Under the tax treaty between Cyprus and Russia, capital gains from the disposal of movable property (including shares) are only taxed in the country of residence of the transferring party. However, the protocol now specifies that capital gains on the sale of shares in companies that hold more than 50 percent of their assets in real estate are also taxed in the country in which the estate is located (in Russia the rate of taxation is 20 percent). This amendment is not expected to come into force until 2014.

### *Removal from Russia's black list*

Another effect of the protocol, and in particular the extension of the provision for the exchange of information, will be that Cyprus should be removed from the black list drawn up by the Russian tax authority. However, dividends paid by a Cypriot company to its Russian parent will not qualify for domestic participation exemption until Cyprus is formally removed from the list.

### Conclusion

The new protocol will boost the position of Cyprus as a prime springboard for investments in and by Russia (the effects deriving from the exchange of information for individuals resident in Russia with stakes in Cypriot companies or foreign corporations managed in Cyprus require further analysis).

## ITALY - SWITZERLAND

### *Deductibility of expenses for promotional activities by a Swiss company.*

The Italian tax authority has issued a new Ruling (No. 100 of 8 April 2009) upholding its previous decision (Ruling No. 427/E 2008) according to which Italian taxpayers cannot deduct expenses incurred in connection with promotional activities and media services provided by a Swiss company which, although it has its own premises and staff, benefits from a low rate of taxation.

### *Legislation on the deductibility of expenses*

The parent company, resident in Germany, had requested a ruling to allow the disapplication of the provision of article 110, par. 10 of the Italian Consolidated Income Tax Law whereby amounts paid to companies resident in Switzerland and benefiting from a low rate of taxation cannot be deducted from the taxable base in Italy. According to article 110, par. 11 of the Consolidated Income Tax Law, taxpayers may request to disapply the provisions of the previous paragraph in the case of foreign companies engaged primarily in genuine business activities or if the transactions were grounded on genuine

business reasons and were actually carried out.

### *The request*

The parent company submitted a specific request to disapply the provisions governing the deductibility of expenses by virtue of the fact that the Swiss company was engaged in genuine business operations, as borne out, among others, by its use of offices and staff (seven employees).

### *The reply*

In confirming its previous position (Ruling No. 427/E 2008), the Italian tax authority held that, taking into account the business that was carried on (and the allocation of suppliers and customers), the Swiss company could not be considered as “established” in Switzerland. According to the tax authority, the existence of a physical structure (offices and staff) does not constitute sufficient proof of a genuinely “established” business. It took the absence of any structural connection with the Swiss economy to mean that there were no legal-economic reasons to justify the company’s establishment in Switzerland.

### *Comments*

We have no option but to acknowledge the opinion of the Italian tax authority. However, as stated above, it is difficult to understand why the Swiss company, which has an organisational and physical structure and also employs seven people, should continue to be considered as having no economic, political, geographical or strategic ties with Switzerland.

In the view of the tax authority, this interpretation, which is now applied indiscriminately in relation to a multitude of anti-avoidance measures (for instance with respect to CFC

rules), is borne out by several decisions of the European Commission on the issue of state aid (Decision 13/02/2007 and 12/12/2007) and a number of rulings by the European Court of Justice (Cadbury Schweppes). Along this line of interpretation, a company is established and thus deemed to carry on genuine business activities in a country when it permanently and continuously contributes to that country’s economy. However, the tax authority has adopted a restrictive interpretation of the concept of establishment, on the basis of which certain activities (usually regarding trade) do not, per se, fulfil the conditions for economic, political and strategic connection with the country.

However, the position of the Italian tax authority does not appear to mirror either the EC Decision, which concerned a different legal context (state aid), or EU case law. In the above-mentioned sentence, the EU Court of Justice did not make any distinction as regards the activities engaged in, underlining instead the importance of actual establishment (particularly in terms of premises, employees and equipment). Thus CFC legislation should only be applicable to “wholly artificial” arrangements, set up without engaging in genuine activities in the country in which they are located.

At a time of rapid expansion, perhaps efforts should focus more on reconciling anti-avoidance requirements with the operational and organisational needs of companies doing business in international markets. This would need to bear in mind the general principle of freedom of establishment, but also the economic and legal characteristics of the countries where Italian companies are established.