Italy issues guidance on dividend withholding taxes

On 8 July 2011, the Italian Revenue Agency (Revenue) issued Circular Letter No. 32/E (Guidance) providing clarifications on outbound dividend withholding taxes. The Guidance explains how, under the principles expressed by the EU Court of Justice (ECJ) in judgment C-540/07, certain EU companies might achieve a refund of the Italian tax levied in excess of the tax applicable to domestic recipients. While addressing the mechanics for such a specific refund, the Revenue provides important clarifications that may be of help in understanding the level of substance required to qualify for favorable withholding tax regimes in other scenarios.

Highlights

EU companies that do not qualify for the exemption under the EU Parent Subsidiary Directive may still qualify for a beneficial 1.375% dividend withholding tax, under certain conditions. Companies that reside in non-EU countries that are part of the European Economic Area (EEA), can also qualify.

This rule was introduced in 2008 after an EU infringement procedure in order to equalize the treatment of EU and EEA recipients with the one applied to Italian companies that, starting in 2004, benefitted from a participation exemption regime on dividends.

However, the reduced rate for EU and EEA recipients under the 2008 rule was applied to dividends paid out of profits generated from financial periods starting after 31 December 2007, thus still allowing for better treatment of Italian companies in respect to payments made starting in 2004 and out of profits generated in any year.

While some EU (and EEA) companies had already started refund procedures, the position held in their claims was further strengthened by the 2009 ECJ decision (C-540/07) on the above-mentioned infringement procedure, whereby the Court stated that equal treatment on dividend
taxation should have been recognized due to the introduction of the participation exemption regime for domestic dividend payments in 2004.

The Guidance specifically recognizes the right to such a refund under certain prerequisites.

This Alert is of primary interest to groups with EU and EEA resident companies that have suffered from an Italian withholding tax higher than 1.65% / 1.375% on dividends received less than four years ago. Also, it may be of help, to have a better general understanding of the level of substance that a foreign recipient needs to meet in order to qualify for beneficial regimes from the perspective of the Italian tax authorities.

Background

Dividends distributed to EU companies qualifying under the EU Parent-Subsidiary Directive are exempt from Italian withholding taxes. Current requirements in order to benefit from such exemption include 10% participation held for at least one year and the recipient being subject to the corporate income tax in its state of residence. The exemption is, in principle, also recognized for EU subsidiaries of non EU groups, to the extent that such subsidiaries were not established for the sole or main purpose of benefiting from the regime at issue.

On 1 January 2004, Italy introduced an exemption regime for dividends paid in a domestic scenario. Under this rule, Italian companies were granted a 95% dividend participation exemption, with the corporate income tax being applied only on 5% of the dividend. This resulted—during the years from 2004 to 2007—in a 1.65% effective tax rate (i.e., 33% corporate income tax rate over 5% of the dividend base), and from the year 2008 to the present day, the effective burden is 1.375% (i.e., 27.5% corporate income tax rate over 5% of the dividend base).

Nonresident companies (without an Italian permanent establishment to which the participations are effectively connected), other than EU entities benefiting from the Parent Subsidiary Directive remained subject to the Italian domestic withholding tax. The domestic withholding is levied at 27% with a refund available (corresponding to the corporate income tax suffered by the recipient in its state of residence) up to the limit of four ninths (4/9) of the Italian withholding (i.e., up to 12% of the dividend). As an alternative, reduced rates could apply under any applicable double taxation treaty (usually ranging from 5% to 15%, depending on the case).

In order to recognize equal tax treatment (under the non-discrimination principles embedded in the relevant EU and EEA treaties) to dividends paid to Italian companies and those paid to recipients resident of EU and EEA countries, a reduced 1.375% withholding tax was introduced (i.e., equal to the effective tax rate applied on dividends received by Italian companies from 1 January 2008) in compliance with an EU infringement procedure. EU and EEA residents were, in practice, granted a 95% dividend exemption regime similar to Italian recipients. To benefit from this favorable withholding tax rate, the beneficiary, among other requirements, must be subject to the corporate income tax in its state of residence.

Nevertheless, the new rule only applied to profits generated during the financial years, starting after 31 December 2007, thus equalizing the tax treatment of EU/EEA and Italian recipients only in respect to the distributions related to such proceeds. However, with reference to dividends paid in the period from 1 January 2004 to 31 December 2007, (for which Italian recipients were taxed at an effective rate of 1.65%) and also to those paid in 2008 out of prior year profits (for which Italian recipients were taxed at an effective rate of 1.375%), EU and EEA companies were still treated less favorably by being subject to the higher domestic or treaty rates.

On 19 November 2009, the ECJ (C-540/07)-involved as the third stage in the EU infringement procedure—ruled that the Italian Republic failed to fulfill its obligations under the free movement of capital principle (Article 56.1 of the EC Treaty) since dividends distributed to companies established in other Member States were subject to a less favorable tax regime than the one applied to dividends distributed to Italian resident companies. The Court specified that equivalent treatment should have applied from
2004, the year when the dividend participation exemption regime was first introduced for Italian companies and under the same conditions recognized for such resident entities.

The refund procedure

Based on the principles expressed by the ECJ in the aforementioned judgment, the Guidance explicitly recognizes the right, in favor of EU and EEA residents, to benefit from the 95% exemption in respect to dividends paid out of profits accrued before 1 January 2008 (i.e., including all profits generated prior to any tax period starting after 31 December 2007).

Specifically, EU and EEA residents are to be granted a reduced 1.65% (i.e., 33% X 5%) withholding tax for the dividends paid from 1 January 2004 to 31 December 2007 and with a reduced 1.375% (i.e., 27.5% X 5%) withholding tax for dividends paid (out of whatever financial year profits) starting on 1 January 2008.

As a consequence, any higher withholding tax applied to dividends paid out of profits accrued before 1 January 2008 shall be refunded for the difference with the aforesaid reduced rates.

The refund, however, is subject to certain requirements addressed by the Revenue.

Subjective requirements

Parent Subsidiary Directive
The Guidance clarifies that refund claims, associated with dividends paid in relation to participations qualifying for the Parent Subsidiary Directive, are excluded from the procedure at stake, as they follow a different regime.

EEA recipients
The Guidance merely observes that the non-discrimination principle stated by the ECJ only relates to dividends paid to EU recipients. While this observation is clearly not in favor of EEA claimants, one could believe that even if EEA companies may not formally count on the binding effect of an ECJ decision, they can strengthen their refund claim by making reference to the aforementioned judgment.

White list
The reduced withholding tax requires the recipients to be residents of the countries included on an Italian "white list," including states signatories of tax treaties with Italy that contain an exchange of information clause. While the final list is still to be issued, the Guidance clarifies that a reference is currently made to the Ministry of Finance decree of 4 September 1996. This list also includes countries that signed a double taxation treaty with Italy, containing an exchange of information clause. Among the non-EU countries that joined the EEA, Norway is part of this list and, although not included, the Guidance explicitly extends the white list status to Iceland; Lichtenstein is excluded.

Objective requirements

Timing
The Guidance clarifies that the refund claims are limited to dividends subject to the Italian tax regime in place starting on 1 January 2004 (i.e., dividend participation exemption) since the ECJ has only examined the discriminatory effects resulting from this regime.

It is also clarified that the relevant refund claims must be filed no later than 48 months from the date on which the Italian tax was withheld, as established for any tax refund under article 38 of the Presidential decree 602 of 1973.

Subject to tax clause
The Guidance notes that the Italian rule under scrutiny was considered, by the ECJ, to be in conflict with the EU principle of free movement of capital. This violation resulted because, in effect, EU companies were dissuaded from investing in the equity of Italian companies as opposed to Italian investors. Thus, claimants should be admitted to the refund procedure only if they have actually or potentially suffered a limitation from investing in Italy.

Accordingly, the Guidance refers to the same concept outlined in a past guidance concerning clarifications on the direct application of the dividend reduced rate (Circular Letter No. 26/E of 2009). Foreign companies must prove that they have been subject to the local corporate income tax. This prerequisite is met irrespective of the company benefiting from exemption regimes provided for specific items of income (e.g., passive income exemption) or in connection to certain territorial areas. In contrast foreign entities excluded from taxation because of their legal nature should not be
eligible to the refund procedure (e.g., this may concern under certain circumstances, entities such as trusts, partnerships and exempt institutions).

Claimants will need to prove their tax status by filing the proper documentation.

**Burden of proof and imputation system**

The Guidance notes that, based on the domestic rules, the burden of proving the prerequisites associated with a refund, always remains with the taxpayer asking for such a refund.

In this respect, it is clarified that, when proving their tax status, claimants will also need to demonstrate that the application of the full Italian withholding tax has actually triggered a worse tax treatment than the one suffered by Italian recipients.

In computing the final tax burden, the foreign company will also have to consider the favorable impact of any foreign tax credit recognized by the home tax system in respect of the Italian withholding tax. Should the Italian withholding tax be entirely creditable against the residence tax, the refund would be denied.

**Actual establishment in the EU**

The Guidance excludes from the refund procedure, companies acting as conduits (conduit companies) and companies carrying out conduit transactions (conduit transactions).

Conduit companies include cases of artificial structures, whereby the EU entity holding the participations in the Italian company lacks an “actual business” or an “actual structure.” The Guidance recalls the concepts expressed by the ECJ in the *Cadbury Schweppes* case (C-196/04) where it was stated that the establishment of a company must be evaluated by considering the presence of premises, personnel and equipment. The structure must be justified under a business purpose and be supported by proving the actual activity performed by the company, together with a coherent level of assets. Thus, actual business and actual structure will be specifically taken into consideration when processing the refund claims.

Conduit transactions include practices by which an EU entity acquires and shortly transfers the Italian participations back after having benefited from the reduced dividend withholding, which was not accessible to the original owner. As to the meaning of conduit transactions, reference is made to the concepts expressed by the ECJ in the *Glaxo* case (C-182/08).

As opposed to the requisites mentioned in the prior subparagraphs, the burden of proof concerning the existence of conduit companies and conduit transactions is on the tax authorities. This is because, as explained by the Guidance, these represent cases of fraud and are not just prerequisites to access a refund.

**Holding companies**

The Italian Revenue tends to consider a company as a wholly artificial arrangement if there are no premises, personnel and equipment. However, the Guidance recognizes that holding companies cannot be judged by this standard since their activity requires no substantial premises.

Reference is therefore made to ECJ State Aid case law (C-222/04), under which the mere retention of participations (without any activity other than cashing dividends) was not considered enough to substantiate an actual business. On the contrary, the actual management and control of the subsidiaries, as well as providing services to them, would qualify the holding company to the refund.
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