Italy Clarifies Tax Haven Rules for Service Payments

POSTED ON FEB. 15, 2007

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Italian tax authorities have issued a circular letter (no. 1 of January 19, 2007) that provides their first interpretation of antiavoidance rules for services rendered by individuals resident in tax havens.

Background

Article 1, paragraph 6 of Law Decree 262 of October 2, 2006, added a new provision to article 110, paragraph 12 *bis* of the Italian Income Tax Code (ITC). That article contains the main rule for disallowing deductions of expenses related to goods and services sold by companies located in tax havens.

Article 110, paragraph 10 of the ITC limits the deductibility of expenses and other deductible items if they relate to transactions between a resident person (individual or company) and a company resident in a country or territory outside the European Union that has a "privileged tax regime" according to a blacklist issued with the Ministerial Decree of January 23, 2002. (The anti-tax-haven regime does not apply to transactions with foreign companies that are subject to Italy's controlled foreign corporation legislation.)

Article 110, paragraph 11 of the ITC provides a safe harbor clause, according to which the expenses at issue are deductible if the resident proves either that the nonresident company carries on a real business activity or the relevant transaction had a real business purpose and actually took place.

Circular Letter

Basically, article 110 restricts the deductibility of payments to tax haven companies, but an individual taxpayer can provide evidence that his expenses are connected to an effective business or professional activity with a private letter of ruling, according to article 11, paragraph 13 of Law 413 of December 30, 1991.

That clarification was not included in the previous text of the law decree in the first draft of the bill presented to the lower chamber of the Italian Parliament. The January 19 circular letter clarifies that taxpayers are allowed to apply for such a ruling.

According to tax authorities, the term "individual" must be broadly interpreted. Any individual whose habitual activity (even if not exclusive) is of a professional nature as defined in article 53 of the ITC is included in the new antiavoidance provision.

Consequently, the definition includes any individuals acting on their own, even if their profession is not recorded in a professional register.

The word "located" also must be defined to include not only individuals located in tax havens but all taxpayers in any way related to a tax haven, including individuals whose fixed base is available in a tax haven.

Blacklist

The Ministerial Decree of January 23, 2002, provides a blacklist of countries and territories that Italy considers to be tax havens.

Article 1 of the Ministerial Decree provides a list of countries and territories where the antiavoidance provision can be generally applied to corporations and limited companies whose business activity is located therein, regardless of what kind of business they conduct. Article 3, paragraph 1 lists countries and territories to which the provision applies only for particular kinds of businesses and specific tax regimes.

The circular letter states that the same provision cannot be applied to individuals, because article 3, paragraph 1 refers only to particular business activities performed by entities. However, article 3, paragraph 2 provides that the list of countries under paragraph 1 applies to services performed by any person; therefore, it could be argued that individuals should be included.

Italian Tax Treaties

Generally, Italy's antiabuse legislation may conflict with its tax treaties with third countries that are included on the blacklist and that contain clauses similar to article 24, paragraph 4 of the OECD model tax treaty, which states:

Except where the provisions of paragraph I of Article 9, paragraph 6 of Article 11, or paragraph 4 of Article 12 apply, interest, royalties and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State. Similarly, any debts of an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable capital of such enterprise, be deductible under the same conditions as if they had been contracted to a resident of the first-mentioned State.

Consequently, if a treaty contains such a nondiscrimination clause, the deductibility of expenses should not be limited merely on the basis of domestic anti-tax-haven legislation. That issue arises in Italy's tax treaties with the Philippines, Singapore, Switzerland, and the United Arab Emirates. However, Italian tax authorities have not taken any position on the issue.

Conclusion

The new provision, as interpreted by the January 2007 circular letter, is only a more extensive application of article 110 to professional services. Under a domestic tax law perspective, the denial of a professional expenses deduction is coherent with the statement that deductions are a matter of legislative grace; taxpayers have no intrinsic right to them. In this case, the burden of showing the right to the claimed deduction is on the taxpayer.

In fact, article, 109, paragraph 5 of the ITC allows the deduction of all ordinary and necessary expenses incurred during the tax year in carrying on any trade or business, if the expenses are directly related to the trade or business of the taxpayer and to the production of profits.

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