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The so-called “foreign-dressing” (esterovestizione)

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Summary

1. The definition of the foreign-dressing
2. The italian tax residence of the legal persons
3. The legal presumptions of the foreign-dressing
4. Foreign-dressing and permanent establishment
5. Considerations on the compatibility with the EU Law
6. Final remarks

1. The definition of the foreign-dressing

- The Foreign-Dressing (hereinafter also F-D) is essentially the **fictitious location of the residence for tax purposes abroad** (so, a tax avoidance special case), not necessary in tax havens but even in EU countries and territories in any case other than Italy, where instead the company actually should reside according to the italian regulations, **to avoid the obligations foreseen by the Italian tax law** and to obtain the application of more favorable tax rules in force elsewhere.

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The definition of the foreign-dressing

The basic assumption of the F-D

From the italian tax authorities' point of view, **if the company's partners or the managers/directors are italian tax residents, producing and accepting money** (dividends, profits, etc.) **on behalf of a non resident company, directly in Italy, they demonstrate probably the "foreign-dressing" of the company** itself **because the place of effective management is here**. Otherwise, why do they still stay in Italy while their business runs mainly outside our boundaries? How is it possible? Is this organization model true or false?

These are the questions that led our legislator in 2006 to introduce the foreign-dressing rule, so trying to give one more legal tool to find the specific solutions against the fictitious location for tax purposes abroad of italian companies or other legal persons. A very recurring situation in our experience, normally used to hide passive incomes.

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The definition of the foreign-dressing

So, the partners/managers already pay the IRPEF (Income Tax for Individuals) in our Country and this is right because of their italian residence for tax purposes,

but according to the new F-D rule, the solution adopted in the 2006 is :

- **their company therefore should pay the IRES** (Italian Corporate Income Tax hereinafter also ICIT) **in Italy for the profits and incomes wherever realized** (according to worldwide taxation principle)**, unless it is proved by facts that the foreign company really has the "beating heart" abroad, so it's really a non-resident entity;**
- **otherwise it will be regarded as resident in Italy for tax purposes.**In

The definition of the foreign-dressing

More technically, this particular case of international tax planning normally foresees a foreign-dressed holding company, located in jurisdictions that guarantee the *participation exemption* taxation, in which to place shares in italian companies, destined to be sold later in an *exemption* tax regime, using the conventional clauses that provide for the right of taxation exclusively in the State of residence of the holding and allowing the subsequent return of capital gain in Italy, completely free from any taxation here, in the form of dividends.

The introduction of the PEX tax regime even in Italy, although it has highly reduced the tax convenience of such tax plans, do not remove them at all, anyway, because of the very stricts requirements under art. 87 of the Italian Income Tax Code.

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The definition of the foreign-dressing

- The foreign-dressing of residence for tax purposes can be so better defined as the **fictitious location of a non-individual taxpayer abroad, in other countries or territories in order to be qualified for more favorable tax treatment, avoiding the application of the italian tax rules**. In other words a company - that should be considered italian tax resident, according to our law – pretends to be a tax resident in another place. Simply it doesn't exist in our Country (if, as usual, it doesn't produce directly or formally any profit in Italy using a branch, subsidiary or a PE, it's not a non-resident taxpayer neither).

- This leads to the phenomenon of **dissociation between formal and substantial residence for tax purposes**.

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The definition of the foreign-dressing

The models of taxation, of course, are the following two:

1. Source based or territorial taxation principle;

2. Worldwide taxation principle.

2. The italian tax residence of legal persons

- In the **OECD Model (art. 4)** we only find the reference to the domestic law of the Contracting States.

- In the **italian tax system**, as well as in most other jurisdictions, the taxation basis for foreigners working in Italy but who are not classified as residents is different to the residents' basis. **Non-residents taxpayers** are only taxed on income and gains arising in Italy, compared to worldwide income and gains for **residents taxpayers**.

2. The italian tax residence of legal persons

•Focusing on the **italian resident taxpayers**, in the Presidential Decree No. 917/1986 *Testo Unico delle Imposte sui Redditi* or T.U.I.R. – Income Tax Code we find out two key provisions:

✓ **art. 75, worldwide taxation principle**;

✓**art. 73, connection of the taxpayer with the territory of the State** based on formal and substantial requirements, to be considered as alternative, for the greater part of the taxable period (it means that requirements must be fulfilled for at least 183 days).

1.formal requirements: the legal seat (indicated in the company's articles of incorporation or statute *ex* art. 2328 Civil Code);

2.material requirements: the place of effective management (central administrative office, headquarter) or the place where the business is mostly carried (main or exclusive business purpose, qualified in the par. 4 and 5, run in Italy).

Favor legis in hiring as a key parameter of tax residence the real seat of the headquarter rather than the place of exercise of the main corporate business.

2. The italian tax residence of legal persons

- **Legal persons having at least one of the above requirements are considered resident in Italy for tax purposes (with regard to the CIT)** and therefore taxable for incomes everywhere obtained, on the basis of the worldwide taxation principle.

- **Normally the burden of proof** – throughout the all process of the tax assessment - **falls in the hand of the tax administration**, **which is obliged to give the evidence** that the information provided by the taxpayer (about the its business organization) are not corresponding to the reality; in other words, **that the requirements listed in the art. 73 T.U.I.R. are not**

3. The legal presumptions of the foreign-dressing

MEASURES TO COUNTER TAX EVASION AND TAX AVOIDANCE (Law 248/2006, Title III, Art. 35, para. 13)

Legal rebuttable presumption (meaning that they're rejected if proven to be false or at least thrown into sufficient doubt by the evidence) **of existence in Italy of the place of effective management of companies and other institutions.**

- The legislator – Visco-Bersani Decree (Law-Decree July 4, 2006, No. 223, converted into Law No. 248 of August 4) – added the **paragraphs 5*bis* and 5*ter* in the art. 73 T.U.I.R.**: **two new rules containing a rebuttable presumption of residence involving a reverted burden of proof,** which falls this time in the hands of the taxpayer.

3. The legal presumptions of the foreign-dressing

Circular letter No. 28/E of 4/08/2006

- *"The strategy to combat the foreign-dressing phenomena, contained in the LD 223/2006, is consistent with the guidelines of the Supreme Court on the actual location of a company";*
- *"the new standard will serve as a tool to counter circumvention practices aimed at substance over form";*
- *"the paragraph makes it applicable also in cases in which we found, among the residents, foreign sub-holding and for this purpose is not relevant to the length and complexity of the investment chain".*

3. The legal presumptions of the foreign-dressing

Art. 73 T.U.I.R., par. 5bis, introduced by Law Decree 4 July 2006, No. 223 (converted in Law 4 August 2006, No. 248) and applicable as from the taxable period commencing 4 July 2006, **contains a rebuttable presumption of residence in Italy for companies established abroad**, which deems such companies to have the place of effective management in Italy if the following conditions are met.

- ✓**Such companies own majority holding stakes**, according to Art. 2359, para. 1 c.c., **in companies or other commercial entities resident in Italy and alternatively**:

3. The legal presumptions of the foreign-dressing

i. **Such former companies are controlled**, also indirectly, according to Art. 2359, para. 1, **by italian resident for tax purposes**; or

i. **Are managed by a board of directors**, or by other equivalent organ of the company, **composed mainly by members resident in Italy for tax purposes**.

3. The legal presumptions of the foreign-dressing

Art. 73, par. 5 ter further clarifies that in order to ascertain the existence of the first alternative condition it is relevant to have regard to the situation existing on the day at the end of the relevant taxable period for the foreign controlled entity.

Insofar as individuals are concerned, it is relevant to also compute the voting rights pertaining to the member of the same family according to the Art. 5, para. 5, of the T.U.I.R.

3. The legal presumptions of the foreign-dressing

The provision at stake does not broaden our ordinary concept of tax residence but merely reverse the burden of proof upon the taxpayer under certain conditions.

The purpose of such rule was to avoid the possibility to escape from taxation in respect of capital gains deriving from the alienation of the shares, which according to the double tax treaties are taxed exclusively in the country of residence of the taxpayer.

3. The legal presumptions of the foreign-dressing

Legal rebuttable presumption effects of the F-D:

1. **A substantial consequence, locating in Italy the place of effective management of the foreign entity and so the residence for tax purposes** applying in this way the w.t.p.(see *tie-breaker rule* of Art. 4 OECD Model);
2. **From the administrative (tax assessment) and judicial point of view, a clear reverted burden of proof up to the taxpayer.**

- Therefore the **tax authorities must notice and prove the conditions launching the presumption, while the taxpayer**, once the presumption is activated, **will be charged with the burden of providing evidence of the opposite**. It will be of course put in relation to the alleged fact, having been called to provide the elements according to which he located abroad, rather than in Italy, the place of effective management of the company.

4. Foreign-dressing and permanent establishment

- It is important to stress that **the foreign-dressed company represents something fundamentally different from a permanent establishment**.

- **the permanent establishment is, therefore, the "*branch of a plant*"**, where, metaphorically, the plant is an independent corporation whose tax residence is not disputed by the Administration.

- Unlike, **a foreign-dressed company represents a "*plant with fictitious roots*"**, because the real tax residence is actually located elsewhere.

5. Considerations on the compatibility with the EU law

- The EU law system doesn’t have its own specific competence in the discipline of direct taxation.
  However, remains the fact that **national tax rules may conflict with it because of the difficult reconciliation with some of the most important principles governing the EU**.

- In our case, **it is possible that art. 73 T.U.I.R.**, with its paragraphs 5*bis*, 5*ter* and 5*quater*, **could limit the freedom of primary establishment** stated in art. 43 et seq. of the EC Treaty as well as the **free movement of capital** under art. 63 TFEU.

- These **italian special rules may also interfere with the prohibition of any restriction of "free outgoing"** for those enterprises wishing to establish subsidiaries in other Member States, since that would be imposed on them a less favorable treatment.

5. Considerations on the compatibility with the EU law

- The question can be resolved only by a ruling of the **European Court of Justice**.
- According to ECJ case law, **Member States may introduce measures which involve a restriction of establishment freedom**.
- However, this does not mean that it is possible an improper use of this autonomy. **Consequently the ECJ ruled that such measures would require two conditions**:
  a) **to be aimed at combating the abuse or circumvention of national law**;
  b) **to be proportionate to the required purpose**.
- It follows that **those presumptions which exclude the evidence to the contrary, or making it extremely difficult, might be judged contrary to the EU Law**.

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5. Considerations on the compatibility with the EU law

- **The taxpayer should always be given the opportunity to provide reliable evidence of "*sound business purpose*"**, namely the fact that there are strong economic reasons for developing its activities abroad and that the company still carries a real business outside our Country.

- **The italian law, therefore, must be regarded as compatible with this, since there is not any kind of automation in the foreign-dressing rules**, because is therefore left to the taxpayer to provide evidence that invalidates the presumption.

- According to the italian case law, **our tax courts confirmed the tax assessment's result only when it was based on *well-defined and consistent evidence***.

5. Considerations on the compatibility with the EU law

- However, **any interpretation thereof that would make it an unduly burdensome will be automatically incompatible with the EU Law**.

- Thus, it seems interesting to suggest three critical issues:

1. the **lack** - within the italian foreign-dressing rules **- of any reference to the procedure of producing such evidences by the taxpayer**.
2. the **absence of any reference or link to a ruling procedure** (Resolution n. 312/E dated 5 November 2007) such a prior opinion of the administration as for the CFC, for example.
3. Shifting the burden of proof from the side of the financial office to the taxpayer one, means that **the taxpayer must demonstrate that the place of effective management is located not in Italy but abroad**. Such a test is not easy to run, especially if we're thinking to a management holding company (most frequent hypothesis).

5. Considerations on the compatibility with the EU law

- In these cases **it would be appropriate to admit the taxpayer to rely on clear circumstances** (such as the place where board meetings are held, the real seat of the administration, etc.) without prejudice to provide to the tax authority evidences against the legal presumption of F-D.

- **the taxpayer**, to overcome the presumption, **must demonstrate, with *appropriate arguments* and *convincing evidences***, that the place of effective management is not in Italy but abroad (i.e.,where the legal seat is placed). Such arguments must be able to prove - with any form of evidences - a real root of effective management in the foreign country.
  It follows that the tax authorities can refer to the taxpayer arguments and evidences only once the tax assessment is already started).

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Final remarks

- **Is quite acceptable the purpose of the law to oppose evasive behavior for tax purposes**, achieved through the pretended placement abroad of a company actually resident in Italy.

- However, in terms of regulation, **has not yet come to solutions that can be defined satisfying from a systematic point of view** because of:

1. inherent difficulties to identify real connecting links able to find legal circumstances showing unequivocally the taxpayer's ability to pay taxes actually referred to the Italian jurisdiction;
2. *hurdle in identifying suitable evidences to defuse the presumptive legal value* of certain law instruments currently included in our legal system.

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Final remarks

- Consequently, **possible profiles of inconsistency and irrationality in the current rules of law** have appeared**, both with the italian constitutional principles** (ability to pay, right to defense, right to a fair trial, etc.) **than with those of the EU Law** (freedom of establishment, proportionality, etc.).

- Some elements, however, are unshakeable starting points for the full respect of these principles: among them, certainly stands out the need to give less relevance to the criteria of purely formal connection, having to give preference in this matter, to the "substantial" evidence about the place of effective management proved by the alleged foreign-dressed taxpayer.

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Final remarks

- The case of "**static" holding companies** shows critical profiles for sure, because these ones do not carry on an operating activity (or, more in general, a real business).

- For such companies, therefore, the connection criteria used by the italian legislator seem even more inadequate, since they were designed to find out the tax residence of operating bodies.

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Final remarks

- Finally, the need for a legislative intervention or, at least, for a clear and unambiguous interpretation of the F-D rule, is felt in order to the **notification to foreign-dressed subjects of the tax assessment's deeds**, a fixed point in our perspective.
- We should move - no doubt - by the undisputed guarantee of knowing of the tax assessment by the taxpayer established in the statutory seat, who has a right to be aware of all the administrative deeds. A pre-requisite for a full trial of the right of defense.

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