"Tax Planning International Review"

BNA International, London

Italy: Introduction of the deemed residence rule and International tax planning

August 2007

Italy: Introduction of the deemed residence rule and International tax planning

Piergiorgio Valente *and* ***Alan M. Rhode***
Valente Associati GEB Partners, Milan

The late introduction of the "deemed residence rule" in Italy,[1] aimed at tackling cases of foreign-based holding companies established by resident persons for tax-avoidance purposes, along with a net of restrictive tax-provisions brought into the Italian tax system by Law n. 296 of December 27, 2006 (2007 Budget Law),[2] illustrates the broad-scoped effort of Italy to clampdown on elusive tax planning.

According to the deemed residence rule the "place of management"[3] of a foreign-based company is presumed to be located in Italy and, accordingly, the company is considered tax resident in Italy, when:

- the latter holds a controlling participation in an Italian corporation;

and it is either:

- controlled, directly or through a sub-holding, by an individual and/or a company with tax residence in Italy; or

- managed by a board of directors, or any other equivalent management organ, composed mostly by members with tax residence in Italy.

When said conditions are met a reversal of the burden of proof occurs and the challenged company should to produce proper evidence to demonstrate that the place of management is not located in the Italian territory in order to avoid any potential tax and criminal liability in Italy. Hence, the deemed residence rule is one which exclusively concerns the burden of proof within the tax assessment procedure and does not interfere with, or modify, the substantive factors linking companies to Italian tax residence. In fact, pursuant to Article 73(3) TUIR, a company is considered to be resident in Italy when its legal seat, place of management or main business purpose is situated in Italy for the greatest part of the fiscal year. Thus, when the deemed residence rule does not apply, the Italian Tax Administration still bears the burden to prove that either: (a) the place of management is located in Italy; or (b) the main business purpose is carried on in Italy in order to claim the foreign-based company's tax residence in Italy, as always provided prior to the introduction of the rule.

The place of management as a key to determine corporate tax residence

The concept of "place of management" is not defined under national law. Hence, an attempt to interpret its meaning and to provide standard keys for its localisation has been undertaken by the courts and by scholars.[4] Actually, according to the Italian tax administration, a "substance over form" criteria – instead of any standard key fitting all cases – should be applied when assessing whether the place of management is situated in Italy: where the place of management or business purpose are located and even where the articles of association or by-laws state

stipulate it is not necessarily significant for their localisation. However, a "real" connection to the foreign territory should be verified.[5] For instance, when formally appointed directors do not really exert any substantial powers but, instead, only execute decisions undertaken by a different body (the so-called "usurpation of powers", developed by the U.K. courts[6]): the place of (effective) management is often considered the place where the latter resolves issues.[7]

In a decision, recently quoted by the Italian Tax Administration, the Supreme Court stated:

> "place of management is the place where the main management duty is performed over the business activity, that is where the effective core of its interests lies, where the company lives and operates, where deals are handled and where all the business assets and goods are organised and co-ordinated to achieve the goals of the enterprise".[8]

In another decision by the Supreme Court, it was stated that:

> "place of effective management does not coincide with a mere company's address, or with the address of a person appointed just to cure the interests of the company, or to be in charge of a factory or office, but is the place where the overall management of the company is carried on".[9]

With reference to the evidence for the determination of tax residence provided by the articles of association and bylaws of a company, the Supreme Court concluded by stating that through a proper enquiry the tax administration may prove the lack of relationship between fictitious residence (in the foreign State) and effective residence (in Italy).[10]

The deemed residence rule, where applicable, is intended to simplify the system for the Italian Tax Administration where tax residence is concerned, providing a rebuttable presumption concerning the determination of the place of effective management in Italy. Accordingly, Italian tax-officials are no longer required to produce "hard-to-find" circumstantial evidence on where effective management of a foreign-based company is performed, as provided under ordinary rules, but only that the same company holds a controlling participation in a corporation resident in Italy, and, either the former is managed by directors whose greater part is residing in Italy or it is controlled, directly or indirectly, by a resident shareholder (individual or legal entity).[11] After the Tax Administration has assessed the fulfilment of said conditions,[12] the taxpayer must prove that the management is performed in Italy in order to spare himself falling within the scope of Italian tax residence. When the legal presumption is not rebutted, a foreign-based company is deemed tax resident in Italy, where corporate income is taxed on a worldwide basis. Obviously, this results in multiple significant effects from a tax planning standpoint, among which the following should be mentioned:[13]

- capital gains on corporate participations would be subject to taxation (or tax-exemption under the "participation exemption" regime) in Italy according to Article 86 (or Article 87) of the Italian Income Tax Code;
- withholding tax would be applied to dividends, interest and royalties paid outbound to non-resident subjects or to resident beneficiaries receiving these payments outside of any business activity;
- any dividends deriving from subsidiaries located in black-listed countries would be fully taxed;
- conversely, inbound payments of dividends, interest and royalties would be exempted from withholding tax.

In this case, the set up of an intermediate holding company in a foreign country with a favourable tax regime – for example, to reduce withholding tax on interest, dividends and royalties in the payer's Country of tax residence or to defer taxation of foreign sourced income to the moment of dividend distribution in Italy – would be ineffective for tax purposes and could lead to administrative and criminal liability. In fact, in the case where omission to file the tax return for Income Tax purposes occurs, an administrative sanction applies, ranging from 120 percent to 240 percent of the tax amount due.[14] Furthermore, criminal liability may be imposed upon the

company's CFO (or any other competent director) in the case of an omission to file the tax return when income tax unpaid exceeds the minimum threshold of approximately €77,000.[15]

It is understandable that the failure to rebut the legal presumption does not automatically lead to criminal liability and that a specific fraud-intention should be assessed, particularly when it is not obvious that the effective management of the company is carried on in Italy and, thus, the CFO could be unaware of infringing the law.[16] However, in the case of prosecution, the defendant may seek to prove that the scope of tax residence regulations (or of their procedure of application) was uncertain, as provided within the Italian tax system, as this is a way of avoiding criminal liability.[17]

No exhaustive information about the evidence to be provided by companies when trying to prove their foreign tax residence has been given either by the Lawmakers or by the Tax Administration when the deemed residence rule was passed last summer,[18] and no case law is available to date. Nonetheless, a "case by case" approach should be preferred, taking into account, for instance, the corporate structure, the purpose of the (foreign) company's establishment, the nature of the business activity carried out by the latter and other factors.

By and large, most cases may be gathered in two broad categories, defined with respect to the purpose of the company's incorporation outside Italy and to the prospective impact of the deemed residence rule on the case, in the aim to define the correct and persuasive evidence which should be delivered: on one side, the operating company within an international corporate group; on the other side, the non-operating "family holding", set up chiefly for private equity purposes. Admittedly, some "in- between" cases will also occur (*e.g.,* mixed holding companies).[19]

The place of management of operating holding companies

We now look at the case of an intermediate holding company within an Italian multinational group, established in an E.U. Country, for both tax purposes (*e.g.,* lower tax rates, no capital gain taxation, various tax incentives, *etc.*) and management/organisational purposes (*e.g.,* lesser bureaucracy, efficient transportation system for goods, foreign language skills, *etc.*), holding controlling participations in few Italian subsidiaries. The company carries on a business activity, providing services to subsidiaries all over Europe with reference, for instance, to information technology (IT), research and development (R&D), recruiting and so on, with a few hundred employees operating in wide and technologically advanced offices. Nonetheless, in some cases it may be that a company only intended to run an Italian fashion store in a foreign country and, consequently, is made up of a tiny structure with just a few employees. This time the Italian investor has been urged to set up a foreign company, instead of a less-demanding branch, to run the foreign store – either by a local institution (*e.g.,* as a condition for the grant of a licence) or by a merchant bank (*e.g.,* as a condition for the grant of a loan) – and favourable tax regulations or lighter bureaucracy have not borne significant influence upon this choice.

When a company performs a business activity within a multinational group, the deemed residence rule probably represents a minor issue, because the rule has been drawn up chiefly for non-operating holding companies, incorporated in a specific country upon a tax-driven choice and with almost no structure or employees, for managing shareholdings and carrying out financial activities, or for private equity purposes. Instead, when the controlled foreign company carries on a business activity abroad, there is most probably some kind of administration held in the foreign country, at least under the shape of a local manager, and it would be not too difficult for the taxpayer to refute the legal presumption of corporate tax residence in Italy.

When a foreign-based entity either does not hold any controlling participation in an Italian corporation or the greater part of directors are not resident in Italy, the deemed residence rule does not apply; yet, if the foreign-based entity is effectively managed from Italy a tax residence issue could still arise, but this time the burden of proof would fall to the Tax Administration claiming that a company is tax resident in Italy.

When a company is registered abroad and unquestionably carries on the main business purpose in a country other than Italy, the "Gordian knot" would be, at this stage, to determine where the place of effective management is, that being the only criterion left for linking tax residence to Italy. What the term "effective management" means is controversial, as it has to be determined at what stage of decision-making the same would be actually performed, especially "in the case of multi-level hierarchical structures and functional diversification of management duties and responsibilities",[20] which is exactly what occurs within most multinational corporate groups.

Nowadays, a holding company and most subsidiaries within a corporate group are not only in charge of selling or distributing a product (or supplying a service) in the relevant territorial market (the traditional "horizontal integration"), but are also likely to perform determinate "supranational duties" in favour of the affiliated companies, *i.e.,* supplying services of IT or R&D. Moreover, the holding company is also likely to be supervising all the business activities carried out by the subsidiaries with reference to a specific geographic area. Accordingly, we may have to consider different tiers of decision-making: basically, a "high-ranked management", at the level of the ultimate holding company, mostly concerned with the setting up of a common policy/strategy for the European subsidiaries and the issuing of long-term directives, and a "medium or low-ranked management", performed by executives of the subsidiary in the country of establishment, concerning not only operative decisions and day-to-day business, but also the supply of services to other affiliates.

In the light of the fact that the OECD commentary does not provide any decisive interpretative criteria for choosing what rank of decision-source should be important in terms of effective management,[21] a wide range of interpretations exist, according to different countries.[22]

In the United Kingdom, a company incorporated abroad is deemed resident when central management and control is exerted in the United Kingdom. That is the highest level of control of the company business but cannot be equated with the ultimate authority of the shareholders. Rather, it seems better represented by the policy-making decisions of the directors, and the location of the board of directors can be indicative of where central management and control is exerted:

> "in determining whether or not an individual company outside the scope of the incorporation test is resident in the U.K., it thus becomes necessary to locate its place of 'central management and control'. The case law concept of central management and control is, in broad terms, directed at the highest level of control of the business of a company. It is to be distinguished from the place where the main operations of a business are to be found, though those two places may often coincide. Moreover, the exercise of control does not necessarily demand any minimum standard of active involvement: it may, in appropriate circumstances, be exercised tacitly through passive oversight.
>
> Successive decided cases have emphasised that the place of central management and control is wholly a question of fact. For example, Lord Radcliffe in Unit Construction said that 'the question where control and management abide must be treated as one of fact or 'actuality'".[23] It follows that factors which together are decisive in one instance may individually carry little weight in another. Nevertheless the decided cases do give some pointers. In particular a series of decisions has attached importance to the place where the company's board of directors meet. There are very many cases in which the board meets in the same country as that in which the business operations take place, and central management and control is clearly located in that one place. In other cases central management and control may be exercised by directors in one country though the actual business operations may, perhaps under the immediate management of local directors, take place elsewhere.
>
> But the location of board meetings, although important in the normal case, is not necessarily conclusive. Lord Radcliffe in Unit Construction pointed out that the site of the meetings of the directors' board had not been chosen as 'the test' of company residence. In some cases, for example, central management and control is exercised by a single individual. This may happen when a chairman or managing director exercises powers formally conferred by the company's Articles and the other board members are little more than ciphers, or by reason of a

dominant shareholding or for some other reason. In those cases the residence of the company is where the controlling individual exercises his powers".[24]

In Australia, a company is resident when incorporated in the country or, otherwise, when jointly its main business is carried out in Australia and central management and control is exerted in the same country. The Australian Tax Administration defines it as follows:

"this level of management and control involves the high level decision making processes, including activities involving high level company matters such as general policies and strategic directions, major agreements and significant financial matters. It also includes activities such as the monitoring of the company's overall corporate performance and the review of strategic recommendations made in the light of the company's performance.

Possession of the mere legal right to the CM&C of a company is not, of itself, sufficient to constitute CM&C of the company. However, a person with the legal right to CM&C may participate in the CM&C of the company even if they delegate all or part of that power to another, provided that they at least review or consider the actions of the delegated decision maker before deciding whether any further or different action is required".[25]

A different situation arises in South Africa[26] where the place of effective management refers is the only substantive criteria for determining tax residence of persons other than individuals in South Africa (besides that more formalistic of incorporation in the country) and it conceptually identifies effective management with day-to-day supervision of the business activity:

"the place of effective management is the place where the company is managed on a regular or day-to-day basis by the directors or senior managers of the company, irrespective of where the overriding control is exercised, or where the board of directors meets.

Management by these directors or senior managers refer to the execution and implementation of policy and strategy decisions made by the board of directors. It can also be referred to as the place of implementation of the entity's overall group vision and objectives.

Management structures, reporting lines and responsibilities vary from entity to entity, depending on the requirements of the entity, and no hard and fast rules exist. It is therefore not possible to lay down absolute guidelines in this regard".[27]

Similarly, for a long time in New Zealand[28] effective management attached to day-to-day management, in accordance with the OECD Commentary. Until 2000 it stated that:

"New Zealand's interpretation of the term "effective management" is practical day-to-day management, irrespective of where the overriding control is exercised".[29]

Even if this provision was deleted in 2000, it is believed among scholars that the deletion does not necessarily represent a *revirement* of New Zealand's position and that, within criteria adopted in the country to verify corporate tax residence, "centre of management" would cover day-to-day management, while "directors' control" would refer to senior management.[30]

In Italy, the Tax Administration did not provide taxpayers with precise information for determining the concerned level of management. However, on an international stage, the same Tax Administration released an Observation to the Commentary on Article 4 of the OECD model which attached the place of effective management to the territory where business is carried out.[31] In fact, the Tax Administration stated that the place where the main activity of the entity is carried on should be taken into account when determining the place of effective management, instead of focusing only on the place where strategic decisions are taken.[32]

Where group policy is concerned, the greatest factor to take into account when assessing whether the effective management of a subsidiary is provided by the parent company or not is represented by the decision-making freedom of the subsidiary's board of directors. When the latter merely formalises decision taken by

the parent company's board of directors and does not hold any independence, there's a risk that the subsidiary will see its own place of management "attracted" into the parent company's country for tax residence purposes. Alternatively, when the executives of the subsidiary are only influenced by the group policy set by the group's top management, or even when they implement and integrate on a day to day basis long-term decisions made by another board, no usurpation of powers seems to occur and, thus, the source of effective management of subsidiary and parent company does not coincide. Intuitively, the issue concerns more common law countries, where the place of effective management is conceived as the highest level of decision-making (*i.e.,* ultimate holding company), instead of countries where the place of effective management is attached to day-to-day management. On this matter, the Australian Tax Administration asserted that:

> "a parent company which does not involve itself in the Central Management and Control of a subsidiary but ultimately has the power to remove the board in a manner consistent with the constitution of the company does not, for this reason alone, exercise the CM&C of the subsidiary for the purpose of the residence test".[33]

Also, the U.K. Tax Administration focused on the parent/subsidiary relationship:

> "it is particularly difficult to apply the 'central management and control' test in the situation where a subsidiary company and its parent operate in different territories. In this situation, the parent will normally influence, to a greater or lesser extent, the actions of the subsidiary. Where that influence is exerted by the parent exercising the powers which a sole or majority shareholder has in general meetings of the subsidiary, for example to appoint and dismiss members of the board of the subsidiary and to initiate or approve alterations to its financial structure, HM Revenue & Customs would not seek to argue that central management and control of the subsidiary is located where the parent company is resident. However, in cases where the parent usurps the functions of the board of the subsidiary (such as Unit Construction itself) or where that board merely rubber stamps the parent company's decisions without giving them any independent consideration of its own, HM Revenue & Customs draw the conclusion that the subsidiary has the same residence for tax purposes as its parent.
>
> HM Revenue & Customs recognise that there may be many cases where a company is a member of a group having its ultimate holding company in another country which will not fall readily into either of the categories referred to above. In considering whether the board of such a subsidiary company exercises central management and control of the subsidiary's business, they have regard to the degree of autonomy which those directors have in conducting the company's business. Matters (among others) that may be taken into account are the extent to which the directors of the subsidiary take decisions on their own authority as to investment, production, marketing and procurement without reference to the parent".[34]

It is certainly the case that even if the tax residence issue does not involve operating companies of a medium-great sized group it may encompass non-operating companies concerned with management of either real estate assets or financial securities within the same corporate group structure.

The place of management of private equity holding companies

We now consider the case of a holding company, with two brothers participating fully and holding equal shares, incorporated in an E.U. country with a favourable tax regime and controlling two small-sized Italian corporations managed by the same family. This is one of those clear-cut cases at which the deemed residence rule is aimed, as the foreign-based company represents a "tax-saving medium" interposed between the individuals and their companies. In fact, the said structure would lead to a few tax benefits, for example:

- no taxation of capital gains in the case of transfer of the participations held in the Italian companies;
- a lower tax rate in the case of earnings generated by investments of the foreign-based company;
- no withholding taxation on dividends distributed to the shareholders.

Also in the case of a foreign-based "family holding", the taxpayer needs to deliver evidence about: (a) the existence of an administrative seat abroad; and (b) the performance of a management duty by the latter. Being a family holding not a business company, deliverable evidence of any activity carried on in the foreign Country by local directors is unlikely to be as easy to produce as in the case concerning a foreign-based operating company (*e.g.,* a distributor).

We may distinguish between "formal" and "material" elements of evidence to be jointly produced by the taxpayer in order to avoid determining the company's place of management as being in Italy. Elements of formal evidence include:

- minutes of the board of directors held in the foreign country;
- main business purpose in the articles of association to be consistent with corporate structure;
- directors should be resident in the foreign country;
- administrative duties to be centralised in the registered offices of the company.

We may include among the elements of substantive evidence:

- duties of management carried "on the spot";
- documented flow of transactions through local bank accounts;
- the hiring of local staff;
- a tangible turnover amount.

For a long time most inquiries on foreign-based "dummy companies" undertaken by the Italian Tax Administration have been hindered, owing to the fact that a foreign entity could not be traced without significant effort in terms of people and costs. This is because each time an exhausting investigation was required, both in Italy and abroad, to find evidence – mostly documental: letters, bank account statements and the like – confirming there was no substantial business activity held abroad. This procedure required many work-hours to be spent, costs to be borne, not to mention trips to foreign countries, authorisations by foreign Tax Administrations, information exchange and the like. Instead, when a foreign-based company controls an Italian company and most of directors are resident in Italy and it is controlled by an Italian individual or corporation, the deemed residence rule provides a means by which to overcome this entire stage of the tax-assessment procedure and shifts the burden of proof against the taxpayer, who should produce formal and material evidence to spare himself the assessment of tax residence in Italy.

It seems that, after the introduction of the deemed residence rule, the classic example of the "cardboard company", set up in a tax shelter without carrying on any real business activity and managed by a local unrelated company specialised in providing services of fictitious management to off-shores corporations, is somehow bound to be captured within the scope of Italian tax residence.

The deemed residence rule and treaty law

The deemed residence rule could increase the number of dual tax residence cases, since it makes it easier for the Italian Tax Administration to assess corporate tax residence in the country, even if it does not increase the range of factors linking tax residence to Italy. Actually, the rule is not inconsistent with the OECD model and with most tax treaties, as it underlines the paramount importance of the place of effective management as the tie-breaker rule provided by the OECD model and adopted in many treaties to solve cases of dual tax residence, instead of the more formalistic criteria of the place of incorporation.

It seems contradictory that Italy emphasised, through the Observation n. 25 to the Commentary on the Article 4 of the OECD Model, the location where the main business is carried on as the place of effective management and, subsequently,

introduced the deemed residence rule within domestic law, stressing chiefly the influence of Italian resident shareholders over the foreign-based company as a potential indicator of the performance of effective management.

Probably, the former position (place of effective management = place of main business purpose) was meant to attract into the scope of Italian tax residence foreign-based operating companies, while the latter position (place of effective management = place of the controlling shareholder) was meant with reference to foreign-based dormant companies. It may be believed as well that Italy intended not to give much relevance to the place where directors meet and resolve issues, as the Commentary does, owing to the fact that, by virtue of technological development, the old concept of a "physical room" where directors gather is inadequate for the purpose of locating a place of effective management[35] and, furthermore, it is a criterion which can be easily "handled" for tax avoidance purposes, *i.e.,* through the setting up of once-in-a-while meetings in the State where shareholders want the company to be considered tax resident.

The deemed residence rule and E.U. law

It may be argued that the reversed burden of proof provided by the deemed residence rule represents a restriction of the freedom of establishment set forth by Article 43 EC Treaty. A review of the case-law of the European Court of Justice on domestic tax provisions on the fundamental freedoms seems to highlight a development in the position of the Court.

In the *Vestergaard* case the Court stated that imposing a reversal of the burden of proof concerning the deductibility of costs sustained in a foreign country against a taxpayer is in breach of EC law:

> "as regards the question whether the rules of a Member State, such as at issue in the main proceedings, contains a restriction prohibited under Article 59 of the Treaty, it must be observed that, by making the right to deduct costs relating to participation in professional training courses held in an ordinary tourist resort abroad conditional upon the rebuttal, by the taxpayer, of a presumption that such courses involve such a significant tourism element that the costs cannot be treated as deductible operating costs, while such a presumption does not exist for courses held in ordinary tourist resorts located in the said Member State, those rules subject the provision of services constituted by the organization of professional courses to different tax arrangements depending on whether the services are provided in other Member States or in the Member State concerned".[36]

In the *Leur Bloem* case the Court stated – with reference to a Dutch tax provision interpreted by the Tax Administration as denying any tax deferment to mergers not meant to achieve economic and financial unity of two existing entities – that even if Directive 90/434/EEC allows States to refute (or withdraw) tax benefits when an operation has as its principal objective or as one of its principal objectives tax evasion or tax avoidance, and that according to the same Directive when the operation is not carried out for valid commercial reasons, such as the restructuring or rationalisation of the activities of the companies participating in the operation, it may be presumed that the operation is tax elusive or evasive, nonetheless it had to be added that "in determining whether the planned operation has as its principal objective or as one of its principal objectives tax evasion or tax avoidance, the competent national authorities must carry out a general examination of the operation in each particular case. Such an examination must be open to judicial review".[37] Furthermore, the court stated that the laying down of a general rule automatically excluding certain categories of operations from a tax advantage would go further than necessary for preventing such tax evasion or such tax avoidance.

We may think the deemed residence rule does not represent "*a general rule which automatically excludes something"*, as the domestic provision examined in the *Leur Bloem* case – which denied, conclusively, any tax advantage for mergers undertaken through an exchange of shares not finalised to reach an economic and financial unit, implying a tax avoidance purpose – but rather sets forth a reversal of the burden of proof by a procedural standpoint, without precluding any onward judicial review of the case. However, it could be said that the rule still represents *lato sensu* a general presumption of tax avoidance, certainly something to be avoided and in

some circumstances, a case-by-case examination at the administrative stage is required even though this is contrary to what the court stipulated.

While it is not clear as to the relationship between the deemed residence rule and the *Leur Bloem* decision, the development of the "abuse of rights" doctrine[38] within E.U. Law in more recent cases, for example, *Halifax*[39] and *Cadbury Schweppes*,[40] could be understood as leaning in favour of the ongoing effectiveness of anti-elusive provisions even when the latter contradicts the fundamental freedoms of the European Union, but only with regard to the same provisions applying to a set of conditions which the Court developed.

In the *Halifax* case, which focused on the application of the Sixth Vat Directive on elusive cross-border transactions, the Court stated, *inter alia*, that the Sixth Directive must be interpreted as precluding any right to deduct input VAT when the transactions generating the same right constitute an abusive practice. For the assessment of such a practice:

"it is necessary, first, for the transactions in question, notwithstanding formal application of the conditions laid down by the relevant provisions of the Sixth VAT Directive and the national legislation transposing that directive, to result in the accrual of a tax advantage the granting of which would be contrary to the purpose of those provisions. Second, it must also be apparent from a number of objective factors that the essential aim of the transactions in question is to obtain a tax advantage".[41]

Furthermore, the Court stated that when an abusive practice has been assessed "the transactions concerned must be redefined so as to re-establish the situation that would have prevailed in the absence of the transactions constituting that abusive practice".[42] Subsequently, the Court ruled in Cadbury Schweppes:

> "the concept of establishment within the meaning of the Treaty provisions on freedom of establishment involves the actual pursuit of an economic activity".[43]

In fact, in presupposing "the actual establishment of the company concerned in the host member state and the pursuit of genuine economic activity there"[44] the Court also stated:

> "in order for a restriction on the freedom of establishment to be justified on the ground of prevention of abusive practices, the specific objective of such a restriction must be to prevent conduct involving the creation of wholly artificial arrangements which do not reflect economic reality, with a view to escaping the tax normally due on the profits generated by activities carried out on national territory".[45]

In the end, *Halifax* and *Cadbury Schweppes* may provide the grounds on which a rule intended to obstruct the abusive utilisation of tax residence – through the burdening of tax compliance falling on the taxpayer, as in the case of a reversal of the burden of proof – could be deemed not in breach of E.U. law. It may be inferred from the recent case law of the ECJ that the "abuse of rights" principle should not be invoked when a rule provides a conclusive presumption of tax avoidance (*e.g.,* concerning a specific operation), precluding any judicial review, and when the same rule is not proportional with respect to the purpose for which it has been set forth.

Conclusion

Lately, a new focus of attention by the Italian Tax Administration seems to have begun – foreign-based companies with little or no structure. Not only has the deemed residence rule been introduced to overcome the difficult stage of tax enquiries in foreign countries (and an increase in the issuance of tax-assessments is foreseeable); even in cases when there is no ground for the presumption of tax residence to apply, the Tax Administration has intensified its activity of investigation, particularly once the weaknesses and inaction of foreign sub-holding companies within Italian multinational groups have become evident.

This trend is consistent with the anti-evasion campaign recently undertaken by the Italian Cabinet, and to which new tax-restrictions over carry-forward of losses, foreign settled trusts and dummy companies testify.

Currently, the effect of the deemed residence rule on corporate groups is not apparent and some still believe that there is the possibility that the rule will be set

aside by the courts because of an (alleged) inconsistency with E.U. Law or Treaty Law.

However, even if the resulting rule is not as effective as expected for whatsoever reason, the current trend of tax officials focusing more on abuses of corporate tax-residence should not be overlooked and should compel tax advisors toward seeking new solutions in international tax planning.

A "substance over form" criteria should be suggested to taxpayers incorporating a company abroad to avoid any risky or groundless (by a legal standpoint) advice being given to clients, and the old solution of establishing ghost-companies in tax shelters for tax optimisation may no longer be adequate and profitable.

1 The deemed residence rule was introduced by Article 35(13), Law Decree n. 4 of July 4, 2006 (ratified by Law n. 248 of August 4, 2006), amending Article 73(5-*bis*) of the Italian Income Tax Code (TUIR). The provision is effective as of fiscal year in progress on July 4, 2006 (FY 2006 for those companies whose fiscal year and solar year match). The requirement of "control" – held by a foreign entity on an Italian corporation and by Italian individuals or companies on a foreign entity – shall be assessed at the end of the foreign entity's fiscal year and, in the case of control held by individuals over a foreign-based entity, the voting rights of relatives up to a certain degree of kinship shall jointly be accounted for to verify control. The rule does not apply when a foreign-based entity holds a participation in an Italian partnership. No advanced ruling for the setting aside of the rule is applicable.

2 For the first time in Italy, Law n. 296 of December 27, 2006 explicitly stated the application of Corporate Income Tax to trusts. Moreover, it introduced a rebuttable presumption of tax-residence in Italy for trusts settled in black-listed countries, when at least one of the settlors and one of the beneficiaries are resident in Italy, and a conclusive presumption of tax residence in Italy for trusts settled in black-listed countries when any assignment of real estate or real estate rights to the trust occurs subsequently to its settlement. Furthermore, Law n. 296 of December 27, 2006 introduced also a conclusive presumption of non-operation for dormant companies when the latter do not fulfil specific legal requirements, leading to compulsory reporting of a minimum legally-set income. With reference to the carry-forward of losses, some restrictions have been added to the regime of mergers with retroactive effect and to the unlimited carry-forward of losses generated in the first three years following the incorporation of a new company.

3 The place of management is one of the criteria for determining corporate tax residence in Italy and recalls the concept of "place of effective management", used by OECD in the Model and adopted in most double taxation treaties.

4 The place of effective management, according to most Italian scholars, would be the place where the "impulse of will" concerning the business activity of a company springs. See Simonetto, "Delle Società Costituite all'Estero od Operanti all'Estero", *Commentario al codice civile*, 1976, p. 389; Garbarino, *La Tassazione del Reddito Transnazionale*, 1990, p. 186.

5 See the Circular issued by the Italian Tax Administration on August 4, 2006 (N.28/E), para. 8. It is not clear whether the application of the new rule could trigger a "chain-reaction" involving further foreign companies controlled by the entity deemed tax resident in Italy, particularly when the former have no structure and are managed from Italy.

6 In a recent case, the U.K. Court of Appeal ruled that the place of effective management of a Dutch company controlled by a U.K. entity was to be considered located in the Netherlands, even if the Dutch managers were influenced by decision taken abroad, because *'the (Netherlands based) directors of Eulalia were not bypassed nor did they stand aside since their representative signed or executed the document'* (*Wood v Holden;* (2006) EWCA Civ 26). The theory of the usurpation of powers has been the ground floor of another recent decision: *News Datacom Limited and Another v Atkinson,* (2006) SpC 561.
7 See, for example, the decision of the Supreme Court n. 4172 of December 10, 1974.
8 Decision of the Supreme Court n. 136 of January 22, 1958.
9 Decision of the Supreme Court n. 3910 of June 9, 1988.
10 See the decisions of the Supreme Court nr. 2070 of March 24, 1983, nr. 791 of February 5, 1985 and nr. 8040 of July 22, 1995.
11 According to Article 2359(1) of the Italian Civil Code, the term "control" bears a triple meaning: "legal control", *i.e.,* more than half of the voting rights in the shareholders' meeting; "material control", *i.e.,* less than half of the voting rights in the shareholders' meeting, but the share amount is sufficient to control the corporation, owing to the dispersion of shareholding; "*de facto* control", *i.e.,* when control is due, for instance, to the ownership of a patent which makes the licensee dependant upon the owner of the patent (individual or corporation).
12 A simpler task than detecting where strategic or operative decisions are actually conceived, as it occurs when localising the place of effective management.
13 These tax consequences have been listed also by the Italian Tax Administration in the Circular mentioned in Note 4.
14 Article 1(1-3), Law n. 471 of December 18, 1997. When income is produced in a foreign Country, sanctions related to any tax amount due on that income are increased by one-third.
15 Article 5(1), Legislative Decree n. 74 of March 10, 2000. A term of imprisonment ranging from one to three years is provided in case of omission to file the tax return when the omission is intended for tax evasion.
16 See Caraccioli, "L'esterovestizione non porta dal PM", *Il Sole 24 Ore*, August 7, 2006.
17 Article 8, Legislative Decree n. 546 of December 31, 1992
18 The Circular of the Italian Tax Administration mentioned in Note 4 specifies that the taxpayer ought to produce evidence on facts, situations or deeds which demonstrate the "settlement" of effective management in a foreign Country. Actually, the instructions given by the Tax Administration on the proper evidence to be delivered appear to be rather vague.
19 For an overview of the different structures and functions of international holding companies see Valente, "Profili fiscali delle International Holding Companies", *Diritto e Pratica Tributaria*, 1997, LXVIII, n.1.
20 Burgstaller and Haslinger, "Place of Effective Management as a Tie-Breaker Rule – Concept, Developments and Prospects", *Intertax*, Volume 32, issue 8/9, 2004, p. 380.
21 See Commentary on Article 4 of the OECD Model, para. 21-25. OECD believes that for the purposes of assessing corporate tax residence it would not be an adequate solution "to attach importance to a purely formal place criterion like registration"; instead it is suggested to attach importance to the place where the company is actually managed: "the 'place of effective management' has been adopted as the preference criterion for persons other than individuals. The place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the entity's business are in substance made. The place of effective management will ordinarily be the place where the most senior person or group of persons (for example a board of directors) makes its decisions, the place where the actions to be taken by the entity as a whole are determined; however, no definitive rule can be given and all relevant facts and circumstances must be examined to determine the place of effective management. An entity may have more than one place of management, but it can have only one place of effective management at any one time".
22 That is due to the fact that each Country tends to interpret the concept of place of effective management according to domestic law. A "common law approach" (*e.g.,* the United Kingdom and Australia), focused on the place of central management and control, could be distinguished from a "non-common law approach" (*e.g.,* South Africa, Germany and Italy), rather focused on the place of management, which could either be subordinated to a superior organ of control or match with the latter. See Rivier, "The Fiscal Residence of Companies – General Report", *Cahiers de Droit Fiscal International*, 1987, pp. 47-66.
23 *Bullock v The Unit Construction Co Ltd* , 38TC712 (1959)
24 HMRC, Statement of Practice SP 1/90, p. 2
25 ATO, "Income tax: residence of companies not incorporated in Australia – Carrying on business in Australia and central management and control" (2004), para. 13.

26 The Revenue Laws Amendment Act, 2000 (Act No. 59 of 2000) provides that a person different than an individual is resident in South Africa when it is incorporated, established or formed in the Republic; or has its place of effective management in the Republic.
27 SARS, Interpretation Note n.6 of 22 March 2002, p. 3
28 According to Section 241(6 of the Income Tax Act, a company is resident in New Zealand within the meaning of this Act if: it is incorporated in New Zealand, or has its head office in New Zealand, or has its centre of management in New Zealand, or control of the company by its directors, acting in their capacity as directors, is exercised in New Zealand, whether or not decision making by directors is confined to New Zealand.
29 Former paragraph 25 of the Commentary on Article 4 of the Model Tax Convention
30 See Mcculloch, *Corporate Tax Residence in the 21st Century, 2001*, paper from the 2001 Tax Conference of the Institute of Chartered Accountants of New Zealand'; Harris, *New Zealand's International Taxation*, pp. 19 and 66.
31 Observation n. 25 to the Commentary on the Article 4 of the OECD Model: "Italy does not adhere to the interpretation given in paragraph 24 above concerning the most senior person or group of persons (for example, a board of directors) as the sole criterion to identify the place of effective management of an entity. In its opinion the place where the main and substantial activity of the entity is carried on is also to be taken into account when determining the place of effective management".
32 Even if the Observation was not meant to address specifically group policy issues, and it refers mainly to the case of a company with more inner ranks of management, yet it may be also interpreted to infer that, in the case of a business entity, the territory where the business is carried on is significant to determine the corporate tax residence and not, conversely, the Country where the group policy is planned and from which long-term directives are issued out.
33 ATO, "Income tax: residence of companies not incorporated in Australia - Carrying on business in Australia and central management and control" (2004), para. 18.
34 HMRC, Statement of Practice SP 1/90, p. 3
35 See OECD, *Place of Effective Management Concept: Suggestions for Changes to the OECD Model Tax Convention*, discussion draft, 2003.
36 ECJ Case 55/98, para. 21
37 ECJ Case 28/95, para. 48(b)
38 See also Vanistendael, "*Halifax* and *Cadbury Schweppes*: one single European theory of abuse in tax law?", *EC Tax Review* 2006/4, pp. 192-95; Rainer and oth., "ECJ Restricts scope of CFC Legislation", *Intertax*, Volume 34, issue 12, 2004, pp.636-38.; Van de Leur, "Abuse of Law? A Double-edged Sword", *International VAT Monitor*, September/October 2006, IBFD.
39 ECJ Case 255/02
40 ECJ Case 197/04
41 ECJ Case 255/02, para. 74
42 ECJ Case 255/02, para. 75
43 ECJ Case 197/04, para. 54
44 ECJ Case 197/04, para. 54
45 ECJ Case 197/04, para. 55