Clarification on Requirements for Dividend-Withholding Tax Reimbursements in Italy

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On 8 July 2011, the Italian Revenue Agency issued circular letter no. 32/E (the Circular), clarifying the requirements that EU-resident companies must fulfill to qualify for the reimbursement of Italian tax withheld on dividends distributed up until 2008.

The Circular may have an impact on foreign taxpayers that have already filed reimbursement claims with the Italian tax authorities or are still within the 48-month grace period to do so. In fact, the Italian Revenue Agency has officially recognised for the first time that reimbursements are due for dividend-withholding taxes levied until 2008 and has provided guidance to local offices to abandon relevant litigations that are before tax courts.

The Circular also sets forth certain requirements that must be fulfilled in order to demonstrate entitlement to the reimbursement. Some of these may prove difficult to fulfill.

Background

Until 2007, Italian legislation provided for the levy of a withholding tax at a rate of 27 per cent (or a lower Treaty rate, where applicable) on outbound dividend payments not qualifying for the exemption under the EU "Parent-Subsidiary" regime (Directive 90/435/CE). Dividends distributed by Italian companies to other Italian companies, are, however, 95 per cent exempt from corporate income tax (CIT) in the hands of the recipient. This results in an effective taxation of 1.375 per cent (i.e., 5 per cent taxable at the ordinary 27.5 per cent CIT rate).

The Court of Justice of the European Union (CJEU), has ruled several times against domestic provisions of Member States determining the tax treatment of dividend payments based on the foreign residency of the recipient (in particular, ruling of 14 December 2006, C-170/05, *Denkavit*, and ruling of 8 November 2007, C-379/05, *Amurta*). As a result, with Law no. 244 of 24 December 2007, the Italian legislator introduced a new regime with the aim of equalising with domestic dividends the tax treatment of outbound dividends.

In particular, the new regime provides for the levy of a withholding tax at the rate of 1.375 per cent on dividends distributed to companies subject to corporate income tax in an EU Member State or in a State within the European Economic Area (EEA) that allows the exchange of information, namely Iceland and Norway. Pursuant to Law 244, however, this regime was only applicable to dividends paid out of profits realised from fiscal year 2008 onwards (*i.e.,* dividends paid generally from 2009 onwards). Based on this provision, the tax authorities have so far refused tax reimbursements related to dividends distributed up until 2008, by arguing that the new regime did not have a retrospective effect.

However, on 19 November 2009, the CJEU issued a judgment in *EU Commission v Italy* (C-540/07) ruling that, by making dividends distributed to companies established in other Member States subject to a less favourable tax regime than that applied to dividends distributed to resident companies, Italy had failed to fulfil its obligations under the freedom of movement of capital.

This ruling led many EU-resident companies to file reimbursement claims with the Italian tax authorities with respect to dividend withholding taxes levied on dividends distributed up until 2008, i.e., before the previous discriminating regime was repealed. As already mentioned, the Italian tax authorities were reluctant to recognise the entitlement to reimbursement of those withholding taxes. Most of the times, reimbursement claims filed by taxpayers have not been given any response, which under Italian law is considered as a tacit denial, which led many to appeal to the tax court.

The Circular

The Circular clarifies several significant points.

It acknowledges that, in order to ensure full and effective implementation of the CJEU ruling, dividends paid out of profits realised in fiscal years prior to 2008 must also be subject to the same tax regime applicable to dividends distributed to Italy-resident companies, *i.e.*, only 5 per cent taxable at the ordinary CIT rate. Since the ordinary CIT rate was 33 per cent until 2007, it follows that dividends distributed until 2008 (paid out of profits realised in fiscal years prior to 2008) should have been taxed at an effective rate of 1.65 per cent. The withholding tax levied in excess of such rate must therefore, in principle, be reimbursed. Local tax offices are invited to abandon relevant litigations.

However, the Circular also points out that the actual entitlement of foreign taxpayers to obtain the reimbursement is subject to specific requirements, which must be checked on a case-by-case basis by the local tax offices before proceeding with the payment.

Some of these requirements are obvious; for example, the dividend recipient must be a company resident in another EU Member State, not qualifying for the withholding tax exemption under the Parent-Subsidiary regime, typically because the participation in the Italian company distributing the dividends is lower than the qualifying shareholding thresholds. Others, however, are less obvious and may prove difficult to comply with, or at least may increase the administrative burden of the reimbursement procedure.

For example, the Circular stresses that the company claiming the reimbursement must be subject to corporate income tax in its State of residence. The Circular correctly recognises that this requirement is met when the company is in principle subject to tax, regardless of exemptions or tax holiday regimes. From a documentation standpoint, the company claiming the reimbursement must provide a certificate issued by the tax authorities of its State of residence, stating that the company is resident for tax purposes and subject to corporate income tax in that State. The Circular argues that, if the company has actually paid in its State of residence a corporate income tax of an amount that allows the full deduction of the withholding tax levied in Italy, or has been granted a full tax credit pursuant to the domestic legislation of the other State or to the applicable bilateral Treaty for the avoidance of double taxation, then it has not suffered any discrimination that should be restored by the reimbursement of the Italian withholding tax.

This point reflects the CJEU ruling and will drive the Italian tax authorities to refuse reimbursement if the foreign company has obtained a tax credit in its State of residence that fully offsets the withholding tax levied at source. It should be noted, however, that in previous rulings (see *Amurta*, paragraph 84) the CJEU stated that a Member State may not rely on the existence of a full tax credit granted unilaterally by another Member State to a recipient company established in the latter Member State in order to escape the obligation to prevent economic double taxation of dividends in a situation where the first Member State prevents economic double taxation of dividends distributed to companies established in its territory.

From a practical perspective, it is not entirely clear how the absence of tax credits granted to the company in its State of residence with respect to the Italian-source dividends should be demonstrated. In this respect, the Circular contains a somewhat ambiguous statement, which seems to suggest that such circumstances should result from the certificate issued by the tax authorities of the State of residence of the company. If this is the interpretation followed by the Italian tax authorities, companies claiming the reimbursement should be prepared to request from their State tax authorities a certificate that includes the specific statements required by the Circular, otherwise the standard language generally contained in the certificates of tax residence might not suffice.

Another controversial requirement set forth by the Circular is that the payment of dividends to the company claiming the reimbursement does not constitute a part of a “purely artificial arrangement”. A purely artificial arrangement is one where (i) the recipient is a “conduit company”, whose establishment in the other EU Member State is fictitious as the company does not perform any actual economic activity nor has a real “physical” presence there; or (ii) the transaction that gave rise to the dividend payment constitutes an abuse of law, as in “manufactured dividends”, which includes dividend washing or dividend stripping transactions that entail a temporary transfer of the title to the shares and a subsequent return of the shares in the hands of an owner not entitled to the benefits available for intra-EU dividends.

The Circular points out that the burden of proving the existence of a purely artificial arrangement is with the tax authorities, which may cooperate with the tax authorities of the other Member States under EU Directive no. 77/799/CEE on mutual assistance by the competent authorities of the Member States in the field of direct taxation.

When a purely artificial arrangement is deemed to exist, the Italian tax authorities should not simply refuse the reimbursement, but should always give the taxpayer the opportunity to demonstrate the business reasons for the establishment of the company in the other Member State, or for the transactions concerning the transfer of the participation in the Italian company. As regards the business reasons for such transactions, in particular, the Circular states that the tax authorities may request from the taxpayers a self-assessment of the facts and circumstances necessary to evaluate the existence of an abuse of law. As the Circular does not define the scope of the information that the tax authorities can request, it would not be too surprising if taxpayers received questionnaires with an extremely wide array of requests, which may sometimes be difficult to answer.

The Circular also provides some guidelines to local tax offices on the evaluation of the existence of a purely artificial arrangement, with reference, for instance, to holding companies. It confirms that particular caution is necessary in evaluating the artificial nature of a holding company, as frequently holding companies do not have a significant physical presence, but this does not necessarily entail an abuse of the freedom of establishment. In this respect, the Circular makes reference to the jurisprudence of the CJEU in the field of State aids (*Cassa di Risparmio di Firenze S.p.A.*) 10 January 2006 C-222/2004), whereby the Court ruled that

…the mere fact of holding shares, even controlling shareholdings, is insufficient to characterise as economic an activity of the entity holding those shares, when it gives rise only to the exercise of the rights attached to the status of shareholder or member, as well as, if appropriate, the receipt of dividends, which are merely the fruits of the ownership of an asset. On the other hand, an entity which, owning controlling shareholdings in a company, actually exercises that control by involving itself directly or indirectly in the management thereof must be regarded as taking part in the economic activity carried on by the controlled undertaking.

In the context in which this appears, it is uncertain what the Circular means by quoting this ruling. If it were to be interpreted as meaning that, in order to rule out the possibility that the holding company be regarded as a purely artificial arrangement, the holding company must have and actually exercise control over the participated entity, this would clearly be in conflict with the basic requirement for the reimbursement, **i.e.,** that the shareholding does not exceed the qualifying threshold for the withholding tax exemption under the Parent-Subsidiary regime (as is typically the case of small shareholdings held merely as portfolio investments).

Another noteworthy statement made by the Circular is that the reimbursement cannot be executed with respect to dividends distributed prior to 2004. This derives from a strict interpretation of the CJEU ruling, which focuses its judgment on the discrimination of outbound dividends *vis-à-vis* the domestic participation exemption regime (*i.e.*, 95 per cent exemption) applicable to dividend distributions to companies resident in Italy, which has been in force since 2004. Prior to that, the Italian legislation provided for a classic imputation system, whereby Italy-resident companies were granted a full tax credit to avoid economic double taxation on domestic dividends. However, the same arguments used by the CJEU ruling to determine the existence of discrimination could well be extended to the previous system that was in force until 2003, as the different technical mechanism to avoid economic double taxation (imputation versus exemption) was available only for Italy-resident companies. Based on the restrictive approach adopted by the Circular, taxpayers that have filed timely reimbursement claims also related to withholding tax levied on dividends received in fiscal years prior to 2004 can expect the tax authorities will continue to refuse the reimbursement for those fiscal years. However, there are strong arguments for litigating the case before the tax court.