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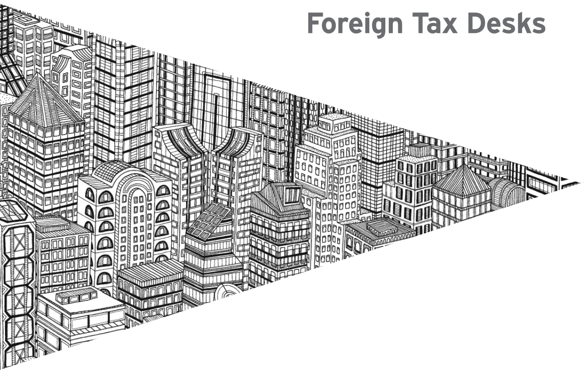

New US income tax treaty and protocol with Italy enters into force

Executive summary

On 16 December 2009, the United States (US) and Italy exchanged instruments of ratification with respect to a new income tax treaty (the New Treaty) and protocol to the New Treaty (Protocol). This completed the final step required for the New Treaty and Protocol to enter into force. The exchange of instruments of ratification was long awaited, as the US and Italy signed the proposed income tax treaty and protocol to the proposed income tax treaty on 25 August 1999 (1999 Proposed Treaty and Protocol).

The New Treaty and Protocol are virtually identical to the 1999 Proposed Treaty and Protocol, except with respect to two reservations which the US required Italy to accept prior to its entry into force: (i) the deletion of certain "main purpose" language aimed at treaty shopping arrangements, which appeared as the final paragraph in the withholding tax provisions of Articles 10 (Dividends), 11 (Interest), 12 (Royalties), and 22 (Other Income); and, (ii) an understanding concerning the exchange of information of Article 26, which would grant the competent authorities of both countries the authority to obtain or provide information held by financial institutions, nominees or persons acting in an agent or fiduciary capacity or relating to interests in a person. These reservations were not formally accepted by the Italian government until February 2007. The Italian Parliament passed a law to authorize the exchange of ratification instruments of the New Treaty and Protocol in March 2009.

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The most significant provisions of the New Treaty and Protocol include the following:

- Reduced withholding tax rates on dividends, interest, and royalties;
- An expanded limitation on benefits (LOB) provision;
- A partial credit in the US for the Italian regional tax on productive activities (IRAP);
- Imposition of the branch profits tax, but at a reduced rate; and
- Addition of formal arbitration procedures under the mutual agreement procedure.

Of particular interest is the LOB article, which mirrors the LOB provision in the 1996 US Model Income Tax Treaty (1996 US Model Treaty). Notably, the New Treaty and Protocol do not extend treaty benefits to entities owned by residents of countries other than the US or Italy such as EU member states or NAFTA countries. Additionally, some of the LOB provisions are not consistent with the expanded LOB provisions that are contained in more recent US tax treaties, which are generally more consistent with the 2006 US Model Income Tax Treaty (2006 US Model Treaty).

The New Treaty and Protocol will take effect for tax years beginning on or after 1 January 2010, however, the withholding tax provisions of the New Treaty and Protocol will take effect for amounts paid or credited on or after 1 February 2010. In cases where the 1985 income tax treaty between the US and Italy (Prior Treaty) provides for more favorable tax treatment, a grandfathering provision allows taxpayers to elect for the application of the entire Prior Treaty for an additional twelve months following the entry into force of the New Treaty and Protocol.

Detailed discussion

The following discussion focuses on the dividends, interest, royalties and LOB articles, and certain other distinctive provisions in the New Treaty and Protocol.

Dividends — Article 10
Article 10 of the New Treaty provides for reduced withholding tax rates on dividends in the amounts of: (i) 5% for dividends paid to a beneficial owner which is a company that owns more than 25% (versus 50% under the Prior Treaty) of the voting stock of the payor and has held such stock for a period of at least 12 months ending on the date the dividend is declared; and (ii) 15% in all other cases.[1] In addition, a qualified governmental entity may be exempt from dividend withholding tax if it holds, directly or indirectly, less than 25% of the voting stock of the payor.[2]

Article 10 also introduces rules for the imposition of a branch profits tax. The branch profits tax is essentially the equivalent of a dividend withholding tax, imposed at a rate not to exceed 5%,[3] on the deemed repatriated profits of a branch (i.e., the dividend equivalent amount). The branch profits tax was not applicable under the Prior Treaty.[4]

The New Treaty does not extend the 5% withholding tax rate to dividends from a US regulated investment company (RIC) or a US real estate investment trust (REIT).[5] However, the 15% rate may apply to dividends paid by a RIC. With respect to dividends paid by a REIT, the 15% treaty rate is available only if one of the following requirements is satisfied: (i) the beneficial owner of the dividends is an individual holding an interest of not more than 10% in the REIT; (ii) the dividends are paid with respect to a class of stock that is publicly traded and the beneficial owner of the dividend is a person holding an interest of not more than 5% of any class of the REIT's stock; or (iii) the beneficial owner of the dividends is a person holding an interest of not more than 10% in the REIT and the REIT is diversified.[6]

As under the Prior Treaty, the New Treaty provides that the reduced withholding rates do not apply in cases where the beneficial owner of the dividend carries on a business through a permanent establishment (PE) in the source state or performs independent personal services from a fixed base in the source state and the holding in respect of which the dividends are paid is effectively connected with the PE or fixed base.[7] Rather, such income is taxed in the source state under its domestic laws, subject to the provisions of the business profits or independent services article of the New Treaty.

Interest — Article 11

Unlike many recently negotiated treaties and protocols with EU member states, the New Treaty does not generally exempt cross-border interest payments from withholding tax. Rather, Article 11 of the New Treaty offers a 10% withholding tax rate (reduced from 15% under the Prior Treaty) on interest[8] and it exempts the following categories of interest from source state taxation: (i) interest paid to qualified governmental entities, provided the entity owns, directly or indirectly, less than 25% of the payor of the interest; (ii) interest paid with respect to debt guaranteed or insured by a qualified governmental entity; (iii) interest paid or accrued with respect to the sale of goods, merchandise or services; and (iv) interest paid or accrued on a sale of industrial, commercial or scientific equipment.[9]

Article 11 of the New Treaty introduces language on the application of a US branch level interest tax, imposed at a rate not to exceed 10%, on Italian companies resident in the US. The taxable base is the excess, if any, of: (i) interest allocable to the profits of an Italian resident company that are either attributable to a US PE or subject to tax in the US under Article 6 (Income From Immoveable Property) or Article 13 (Capital Gains); over (ii) the interest paid by the PE or trade or business in the US.[10]

Similar to Article 10, the reduced withholding tax rates on interest under the New Treaty do not apply in cases where the beneficial owner of the interest carries on a business through a PE in the source state or performs independent personal services from a fixed base in the source state and the interest paid is effectively connected with the PE or fixed base.[11] Rather, such income is taxable in that source state pursuant to its domestic law, subject to the provisions of the business profits or independent services provisions of the New Treaty.

Royalties — Article 12

Article 12 of the New Treaty substantially reduces the withholding tax rates on all categories of royalties (which includes tangible personal property rents) apart from those classified in the "motion picture" category and eliminates the withholding tax rate on certain royalties altogether. The withholding tax rates for royalties under the New Treaty are applied as follows: (i) 0% for royalties paid for the use of certain copyrighted materials;[12] (ii) 5% for royalties paid for the use of computer software and industrial, commercial or scientific equipment; and (iii) 8% for royalties paid in all other cases.[13]

The reduced withholding rates on royalties under the New Treaty do not apply in cases where the beneficial owner of the royalties carries on a business through a PE in the source state or performs independent personal services from a fixed base in the source state and the right or property in respect of which the royalties are paid is effectively connected with the PE or fixed base.[14] Rather, such income is taxable in that source state pursuant to its domestic law, subject to the provisions of the business profits or independent services provisions of the New Treaty.

Relief From Double Taxation – Article 23

IRAP is now formally included within the scope of the New Treaty via Article 2 of the New Treaty. However, pursuant to Article 23(2) of the New Treaty, the amount of IRAP treated as an income tax for purposes of obtaining a credit in the US is limited according to a specified formula which determines the portion of IRAP imposed on the business profits of a taxpayer.

IRAP, which became effective 1 January 1998, applies to Italian residents as well as non-residents of Italy with a PE in Italy. Since IRAP is calculated without a deduction for labor costs and, for certain taxpayers, without a deduction for interest costs, it fails to qualify as a creditable tax under Treas. Reg. Section 1.901-2. However, the US has allowed a partial credit based on a formula first introduced in a press release issued by the IRS in April 1998.[15] Under this formula, which is now included in Article 23(2) of the New Treaty, the creditable portion of IRAP is determined by multiplying the total IRAP paid or accrued by the "applicable ratio." The applicable ratio is the tax base on which the IRAP is imposed less labor and interest not already deducted, divided by the total IRAP base.

Mutual Agreement Procedure – Article 25

Article 25(5) provides for arbitration in cases where the competent authorities of the two contracting states fail to reach an agreement over a treaty dispute within two years. However, this provision shall not have effect until the US and Italy exchange diplomatic notes agreeing to the specific arbitration procedures. A Memorandum of Understanding, dated 25 August 1999 (MOU) stated that the US and Italy will exchange diplomatic notes only after the competent authorities of both countries are satisfied with the results from the EU arbitration convention on transfer pricing matters and the US-Germany tax treaty. As of the date of this Tax Alert, the US and Italy have not exchanged diplomatic notes.

Limitation on Benefits — Article 2 of the Protocol to the New Treaty

Article 2 of the Protocol to the New Treaty contains a comprehensive LOB article, which is substantially similar to the 1996 US Model Treaty. While the LOB in the Protocol takes a similar approach to the LOB provisions in other recent US agreements, there are some material differences (i.e., lack of a derivative benefits clause).

Under Article 2 of the Protocol, a resident company may be eligible for benefits under the New Treaty if it (i) meets the requirements to qualify as a publicly-traded resident of the US or Italy (Publicly-Traded Company Test); (ii) is a subsidiary of which at least 50% of each class of stock is owned by five or fewer companies that qualify as under the Publicly-Traded Company Test (Subsidiary of Publicly-Trade Company Test); or (iii) meets an ownership and base erosion test (Ownership and Base Erosion Test).

Alternatively, a resident company that fails all of the above tests may still qualify for treaty benefits with respect to an item of income if it meets the active trade or business test (ATB Test) or is granted treaty benefits by the relevant competent authority.

Each of these tests is discussed in more detail below.

Publicly-Traded Company Test[16]

A resident company may be entitled to all of the benefits under the New Treaty if all shares in classes that represent more than 50% of the voting power and value of the company are regularly traded on a recognized stock exchange located in either state.

Subsidiary of a Publicly-Traded Company Test[17]

A resident company may be entitled to all of the benefits under the New Treaty if at least 50% of each class of shares in the company is owned, directly or indirectly, by five or fewer companies that qualify under the above Publicly-Traded Company Test. In the case of indirect ownership, each intermediate owner must be a qualified person.

The Ownership and Base Erosion Test[18]

An entity that is a resident of the US or Italy may also be entitled to all of the benefits under the New Treaty if is satisfies the two-prong Ownership and Base Erosion Test. Both prongs of the test must be satisfied for the resident to be entitled to treaty benefits.

The ownership prong requires that at least 50% of each class of shares or other beneficial interests in the entity is owned, directly or indirectly, for at least half the days of the person's taxable year by qualified persons. In the case of indirect ownership, each intermediate owner must be a qualified person. A trust may be entitled to benefits under this provision if it is treated as a resident under Article 4 (Resident) of the New Treaty and it otherwise satisfies the requirements of the Ownership and Base Erosion Test. For purposes of the ownership prong, the beneficial interests in a trust will be considered to be owned by its beneficiaries in proportion to each beneficiary's actuarial interest in the trust.

The base erosion prong requires that less than 50% of the entity's gross income for the taxable year be paid or accrued, directly or indirectly, to non-residents of either state (unless income is attributable to a PE located in either state), in the form of payments that are deductible for tax purposes in the entity's state of residence. For this purpose, payments to any resident of either state, as well as payments that are attributable to a PE in either state, are not considered base-eroding payments (to the extent that these recipients do not themselves base-erode to non-residents). Unlike other treaties, there is no exception for payments made in the ordinary course of a trade or business.

The Active Trade or Business Test[19]
Article 2 of the Protocol provides that a resident of a state that is not otherwise entitled to the benefits of the New Treaty may be entitled to treaty benefits with respect to a specific item of income derived in the other state if it satisfies the ATB Test.

To satisfy the ATB Test, a resident must meet the requirements of the following three-prong test: (i) the resident is engaged in the active conduct of a trade or business in its country of residence; (ii) the income is derived in connection with or is incidental to the business; and (iii) the trade or business is substantial in relation to activity in the other state generating the income. The ATB Test is applied separately for each item of income derived from the source country.

For purposes of the ATB Test, the business of making or managing investments is not considered an active trade or business, unless these activities are banking or insurance activities carried on by a bank, insurance company or registered securities dealer. Additionally, because a headquarters operation is in the business of managing investments, a company that functions solely as a headquarters company will not be considered to be engaged in an active trade or business for purposes of the ATB Test.

Whether the trade or business is substantial is based on all facts and circumstances. However, Article 2 of the Protocol includes a safe harbor under which a trade or business may be deemed substantial if, for the preceding tax year or average of three preceding years, each of the following three ratios are at least 7.5% and the average of the three ratios is at least 10%: (i) asset value ratio, which compares the value of the assets in the recipient's state to the assets used in the other state; (ii) gross income ratio, which compares the gross income derived in the recipient's state to the gross income derived in the other state; and (iii) payroll expense ratio, which compares the payroll expense in the recipient's state to the payroll expense in the other state. The Treasury Department Technical Explanation clarifies that the substantiality prong may only be satisfied if there is common ownership of the activities in both states.

Competent Authority Relief[20]
A resident of the US or Italy that is not otherwise entitled to benefits may nevertheless be granted benefits if the competent authority of the state from which benefits are claimed so determines. This provision recognizes the increasing scope and diversity of international economic relationships and allows the relevant competent authority to use discretion in granting treaty benefits to a resident in cases where such resident is neither a qualified person nor is entitled to benefits with respect to an item of income under the ATB test.

Other provisions
Partnerships are now included in the definition of a "person" under Article 3.

Residents of the US or Italy who are working as independent contractors will no longer automatically be subject to taxation in the other country by spending more than 183 days there. Income from independent services performed in the country of non-residence will now be subject to taxation only to the extent the income is attributable to a fixed base in that country.

Entry into Force — Article 28
The New Treaty and Protocol entered into force on 16 December 2009, the date the US and Italy exchanged the instruments of ratification. The withholding tax provisions of the New Treaty will be effective for amounts paid or credited on or after 1 February 2010, the first day of the second month following the exchange of instruments of ratification. In respect of other taxes, the New Treaty and Protocol will be effective for tax periods beginning on or after 1 January 2010.

Taxpayers who are entitled to greater benefits under the Prior Treaty than under the New Treaty may elect to have the Prior Treaty continue to apply for an additional twelve months. However, any election to delay the effective date of the New Treaty under this provision will apply to the New Treaty in its entirety.

Implications

Generally, the New Treaty and Protocol are consistent in terms of approach with both the 2006 Model Treaty and other recent treaties and protocols, but there are some cases where the New Treaty diverges. In particular, the LOB article in the Protocol is much more restrictive than similar provisions in other treaties since it does not contain a derivative benefits provision, which could have extended treaty benefits to US or Italian resident companies that are owned by residents of countries that are EU member states or parties to NAFTA. Additionally, unlike other recent treaties, source country withholding taxes on royalties and interest may be imposed.

The end of the exemption from the branch profits tax is also another significant item. Although the New Treaty offers reduced withholding rates, the imposition of the branch profits tax may increase the tax implications of some companies that under the Prior Treaty were benefiting from this exemption.

Endnotes

1. Paragraph 2, Article 10, New Treaty.
2. Paragraph 8, Article 10, New Treaty.
3. Paragraph 7, Article 10, New Treaty.
4. *See* Treas. Reg. Section 1.884-1(g)(3).5.
5. Paragraph 9, Article 10, New Treaty.
6. Paragraph 9, Article 10, New Treaty.
7. Paragraph 4, Article 10, New Treaty.
8. Paragraph 2, Article 11, New Treaty.
9. Paragraph 3, Article 11, New Treaty.
10. Paragraph 8, Article 11, New Treaty.
11. Paragraph 5, Article 11, New Treaty.
12. Paragraph 3, Article 12, New Treaty.
13. Paragraph 2, Article 12, New Treaty.
14. Paragraph 5, Article 12, New Treaty.
15. *See* International Tax Alert, *Mutual Agreement Between the United States and Italy on Partial Creditability of Italian Tax (IRAP)*, dated 15 April 1998.
16. Subparagraph 2(c)(1) of Article 2, Protocol to New Treaty.
17. Subparagraph 2(c)(2) of Article 2, Protocol to New Treaty.
18. Subparagraph 2(f) of Article 2, Protocol to New Treaty.
19. Paragraph 3 of Article 2, Protocol to New Treaty.
20. Paragraph 4 of Article 2, Protocol to New Treaty.

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