

# The International Tax Letter

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International news and analysis to help you in your international tax strategy.



## Focus on: ITALY - CFC Regulation can be disregarded if effective tax burden of group is congruous with Italian tax burden



On 28 March 2007, the Italian tax authorities issued a ruling according to which the controlled foreign corporation (CFC) rules can be disregarded if the effective tax burden of a group as a whole is congruous with the level of taxation that should have been achieved by applying the CFC rules even though the controlled company is located in a black listed country.

An Italian company wholly owns a US company, which holds 100% of the shares of a company tax resident in Cyprus (Cyprus is included in the list of tax havens for CFC purposes). The Italian shareholder indirectly controls the Cypriot company, as a consequence of the purchase of the Cypriot shares by a US company. The Cypriot company, which is an holding company, is subject to the ordinary corporate income tax rate (10%). The taxpayer requested that the CFC rules not be applied on the basis that the participation in the Cypriot entity does not achieve the localization of income in a tax haven country.

First, the tax authorities stated that, as the Cypriot company does not carry out an industrial or a commercial activity, the exception provided in Art. 167(5)a) of the ITC is not available. Therefore, it should be verified whether the conditions provided under Art. 167(5)b) of the ITC are met.

The tax authorities ruled that CFC rules can be avoided in the case at stake (based on the exception included in Art. 167(5)b)) on the condition that:

- the Italian shareholder provides each year documents proving the tax burden of the Cypriot company therein; and
- the Cyprus company distributes each year an amount of income that triggers a tax (in Cyprus and in the US) equal to at least 27% of the gross income realized by the Cypriot company (i.e. the tax burden is equivalent to the minimum required in case of application of the CFC rules).

The tax authorities made it clear that the above requirements must be met each year and, in particular, the requirement that the Italian company provide the tax authorities with the documents proving the annual income accrual and distributions by the Cypriot company.

**Opportunities for taxpayers:** For the first time the Italian tax authorities consented to disregard CFC rules if the effective tax burden of group is congruous with Italian tax burden: this rulings shows how to provide the proof to the tax authorities.

## FRANCE - EUROPEAN UNION

### Guideline on implications of ECJ's *Denkavit* case on French dividend withholding tax published

The French tax administration published Guideline 4 C-7-07 on 10 May 2007 on the implication of the ECJ decision in Case C- 170/05 *Denkavit II*, delivered on 14 December 2006.

The Guideline first noted that the facts in question in *Denkavit* covered a situation of control between two companies established within the European Union (i.e. 99.9% and 50%) prior to the implementation of the EC Parent-Subsidiary

## Contents

### FOCUS ON: ITALY

CFC Regulation can be disregarded  
If effective tax burden of group is congruous with Italian tax burden

### FRANCE - EUROPEAN UNION:

Guideline on implications of ECJ's  
*Denkavit* case on French dividend  
withholding tax published

OECD: Revised Commentary on Article 7  
of OECD Model released

INTERNATIONAL MODELS: How to use  
Private Real Estate Fund in Luxemburg



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Directive 2003/123/EC. It noted that currently such dividend distributions are exempt from the French withholding tax under the Directive for participations of at least 15% (10% from 2009).

According to the Guidelines, however, dividends distributed by a French subsidiary to a parent company established in the European Economic Area (except Liechtenstein) will be exempt from French withholding tax from 1 January 2007 provided that:

- the parent company holds at least 5% in the capital of the French subsidiary; and
- the parent company is unable to set off the French withholding tax applicable, because the parent company benefits from a participation exemption regime in its country of residence; and
- the transaction does not constitute an artificial arrangement.

## OECD

### Revised Commentary on Article 7 of OECD Model released

On 10 April 2007, the OECD Committee on Fiscal Affairs ("Committee") released a discussion draft including a revised Commentary on Art. 7 of the OECD Model Tax Convention, as the first part of the implementation package for its Report on the Attribution of Profits to Permanent Establishments. The Committee invited interested parties to comment on the discussion draft preferably before 15 June 2007, or before 1 August 2007 at the latest. The Committee also announced that it expects to release the second part of the implementation package, i.e. a new version of Art. 7 with accompanying new Commentary, towards the end of 2007.

The OECD Committee on Fiscal Affairs (CFA) issued on 10 April 2007 a discussion draft on a revised Commentary concerning Art. 7 (Business profits) of the OECD Model Tax Convention.

The current Commentary provides little guidance on how to interpret the term "profits of an enterprise", beyond rejecting of the force of attraction principle. Two broad interpretations of the term "profits of an enterprise" were developed in that regard, namely the "relevant business activity" and the "functionally separate entity" approach. The proposed Commentary states that Art. 7 should not be interpreted as restricting the amount of profit that can be attributed to a PE to the amount of profits of the enterprise as a whole. Under the proposed Commentary, the application of paragraph 2 may result in profits being attributed to a PE even though the enterprise as a whole has never made profits.

The proposed Commentary indicates that in order to attribute profits to a PE, it will be necessary to determine the profits that would have been realized if the PE had been a separate and distinct enterprise engaged in the same or similar conditions under the same or similar conditions and dealing wholly independently with the rest of the enterprise. This is achieved by using a two-step approach. The first step requires a functional and factual analysis, identifying the economically significant activities carried through the PE. The second step requires to determine the remuneration for such activities by applying by analogy the transfer pricing principles with reference to the functions performed, assets used, and risks assumed, by the enterprise through the PE and through the rest of the enterprise.

The proposed Commentary eliminates several of the existing exceptions to the arm's length principle laid down in the current Commentary. On the related issue of whether a PE may deduct its interest expense on intra-entity loans, the OECD maintains the ban on deductions for internal debts and receivables, with the exception of financial enterprises such as banks.

## INTERNATIONAL MODELS

### How to use Private Real Estate Fund in Luxembourg

Private Real Estate Fund allows both private and institutional investors to invest in a unique direct real estate vehicle, which is a Luxembourg Direct Real Estate Investment Fund (REIF) set up as a SICAF quoted on the Luxembourg Stock Exchange.

The REIF offers several "investment compartments", each with its own investment focus in terms of both property type (offices, retail or logistics centres) and region (Western and/or Central Europe). This allows the investors to choose the compartments that meet their interests.

The REIF is very flexible whether in terms of:

- leverage,
- distribution of income
- asset allocation.

Although the REIF is listed on the Luxembourg Stock Exchange, it is basically a non-liquid investment vehicle with a 10 year investment horizon.

The REIF allows income streams generated in any European Union country to flow within the Structure, fiscally optimised, and with no withholding tax to be withheld by the REIF on revenues paid out. The administration of the REIF is performed in Luxembourg.



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