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The "*Leofin* case"

The Italian Judge thwarts the use of Companies established abroad that are effectively managed in Italy

Legal background

Art. 73 of the Italian Income Tax Act (ITA) indicates the persons subject to corporate income tax in Italy.

Under Art. 73, paragraph 3, of the ITA "*a company or another entity are resident in Italy if either their legal seat, place of effective management or main activity is located in the Italian territory during most of the taxable period*".

The Law n. 248 of 4 August 2006 has added a new paragraph 5-*bis* in Art. 73 of ITA.

Under the new paragraph 5-*bis*, a company established abroad which controls a company or another entity resident in Italy, is deemed to be resident in Italy, if alternatively:

a) the foreign company is controlled, directly or indirectly, by persons resident in Italy; or

b) the majority of the board of managers is made up of persons resident in Italy.

Paragraph 5-*bis* of Art. 73 of the ITA has thus introduced a relative presumption, since the taxpayer may prove the contrary.

The purpose of Art. 73, paragraph 5-*bis*, is to hinder even more the use of companies formally established abroad, when their sole objective is to take advantage of the other Countries' favourable legislation, such as the participation and dividend exemption.

It is worth saying that in the past the Italian tax authorities have countered such practice using the concept of "*place of effective management*" contained in Art. 73, paragraph 3, of the ITA.

In other words, a company established abroad could be deemed to be resident in Italy if it was proved that its "*place of effective management*" was actually in Italy.

In this respect, one can say that Art. 73, paragraph 3, of the ITA is in line with Art. 4, paragraph 3, of the OECD Model Tax Convention.

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In the recent *Luxottica* case, concerning the taxable years 1997 and 1998, the Italian judge made reference to both Art. 73, paragraph 3, of the ITA and Art. 4, paragraph 3, of the OECD Model Tax Convention.

The facts examined by the Tax Court of first instance of Belluno

In the decisions n. 173/01/2007 and 174/01/2007 dated 14 January 2008, the First Instance Tax Court of Belluno examined the case of a German company wholly owned by an Italian company.

Amongst the relevant facts considered by the Italian judge are the following:

- a confidential letter sent by the Italian company to the German subsidiary where it was suggested to hold the shareholders' meetings in Germany, in order to avoid that the German tax authorities considered the German subsidiary resident in Italy;
- the documents and other information regarding the annual balance sheet of the German company were kept in Italy;
- all the German company's relevant contracts were signed by Italian persons;
- the unique shareholder of the German company was Italian;
- the same person was also the manager of both the German subsidiary and the Italian parent company;
- the financial operations of the German company were funded by the Italian controlling company.

The judge referred to Art. 4, paragraph 3, of the Italy-Germany Double Tax Convention which states that: "*Where … a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident of the State in which its place of effective management is situated*".

Accordingly, the aim of the judge was to determine where the "*place of effective management*" of the German company was located.

The criteria selected by the Italian judge to identify the German company's "place of effective management".

The following are the criteria used by the Italian judge in determining where the German company was effectively managed:

1. The substance of the German company's organization to carry out its commercial activities;
2. The German company's degree of independence in choosing its strategies;
3. The nature and relevance of the participation held by the Italian parent company;
4. The fulfilment of the book-keeping and tax duties by the German company.

Furthermore, the judge took into consideration other facts, namely:

5. The circumstance that the capital of the German company was owned by a company whose shareholders were all members of the same family;

6. The circumstance that also the managers of the German company were individuals who were resident in Italy and had family ties with the shareholders of the Italian parent company (even though some of them did not reside in Italy or had a relevant role in the German company).

Conclusions of the Italian judge

In light of the above circumstances, the Italian judge upheld the view of the Italian tax authorities who deemed the German company to be resident in Italy.

This conclusion, in particular, was supported by the following elements:

a) The holding of shares:

"*The German company* - stated the judge - *has been set up in order to hold a number of shares of the group of companies, sell those shares to other companies of the same group and take advantage of the German participation exemption regime*".

b) Residence of the German company's top manager:

The judge observed that the top manager of the German company "*was resident in Italy in the tax year assessed, and was also a manager of the Italian parent company*".

c) Activities of the other manager:

The judge noted that "*the other manager of the German company did not have an effective management role, because the shareholders had expressly relieved him of any responsibility. As a matter of fact, all the relevant deeds of the German company were signed by the Italian top manager or other persons*".

d) Financial and capital independency of the Company:

The Italian judge took into consideration the financial independence of the German Company, stating that "*it had no financial or capital independency and it was completely directed by the Italian company and the Italian top manager, who were both resident in Italy*".

e) Location of the managers' meetings:

The judge examined also the location of the managers' meetings. He stated that it was "*irrelevant that the meetings were held in Germany since the decisions were actually taken in Italy and then recorded in the company deeds through persons acting on behalf of the Italian top manager*".

f) Other confidential document:

The judge also examined the confidential document found by the tax administration, in which the Italian parent company suggested the German subsidiary to hold the shareholders' meetings in Germany "*in*

order to reduce the risk that the German tax administration considers the German company resident in Italy for tax purposes".

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We reckon that the conclusion of the Italian Tax Court was right in that, at the end of the day, the establishment of the German company appeared to be a sham for tax purposes. In fact, the German company was created solely for taking advantage of the German participation exemption provisions (at the time of the facts, *i.e.* 1997 and 1998, the Italian tax system did not have a participation exemption regime).

Since all the relevant decisions of the German company were taken in Italy, and in Italy was also the residence of the company's top manager, it was correct – in our opinion – to deem the German company to be resident in Italy under Art. 73, paragraph 3, of the ITA.

We believe that this conclusion is in conformity with the new presumption of Art. 73, paragraph 5-*bis*, which, under the specific circumstances described at the beginning, shifts the onus of proof concerning the effective residence of a foreign company from the tax authorities to the taxpayer.

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