Italian Tax Reform: Eligibility of New Taxes for U.S. Foreign Tax Credit

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In connection with the issuance of Public Law 662/1996 last December (1997 Finance Act), the Italian Parliament has delegated authority to the government to draft legislation overhauling many areas of Italian taxation. As a result of these decrees, some existing taxes will be abolished and new taxes and levies will be imposed. (For prior coverage, see *Tax Notes Int'l,* Mar. 10, 1997, p. 815, or *Doc 97-6723 (5 pages); Tax Notes Int'l,* Mar. 31, 1997, p. 1029, or *Doc 97-9005 (7 pages);* and *Tax Notes Int'l,* Nov. 17, 1997, p. 1589, or *Doc 97-30375 (3 pages).*) This article briefly analyzes new taxes that will be introduced in Italy and compares their characteristics with the requirements found in Part III, subpart A, of Subchapter N of the U.S. Internal Revenue Code (sections 901 through 908), dealing with the availability of a credit in the United States for foreign taxes paid or accrued.[1]

Italian taxpayers will soon be subject to a new local tax — the *imposta regionale sulle attivitá produttive* (IRAP).[2] These taxpayers may also become subject to a number of substitute taxes. This article first provides an overview of the general U.S. rules regarding the creditability of foreign taxes and then addresses each of the new Italian taxes. When eligibility of the new taxes is questionable, both theoretical and practical solutions are suggested.

I. U.S. Credit Eligibility Requirements — In General

Section 901 allows qualifying taxpayers a credit against their U.S. tax liability for certain foreign levies paid or accrued. Similarly, section 902 allows qualifying corporate shareholders a credit for certain foreign levies paid or accrued by their foreign subsidiaries. For a foreign levy to be eligible for a credit in the United States, it must meet two requirements. First, it must be considered a tax for U.S. purposes. Second, its predominant character must be that of an income tax, as determined under U.S. principles.

The following discussion analyzes the requirements necessary for a foreign levy to qualify as a creditable income tax for U.S. purposes. Examples of foreign levies that have been the subject of rulings or pronouncements from the U.S. authorities are included as appropriate to assist in providing an understanding of how the United States has viewed the inclusion of certain characteristics within prior taxation systems.

A. Classification of Foreign Levy as a Tax

As indicated above, the first requirement for a foreign levy to be creditable in the United States is that the levy be characterized as a tax for U.S. purposes. The classification of a foreign levy as a tax has not always been a clear matter. Under Treas. reg. section 1.901-2(a)(2)(i), a foreign levy will be considered a tax if it "requires a compulsory payment pursuant to the authority of a foreign country to levy taxes."

Two issues that have caused the classification of a foreign levy as a tax to be questioned in the past involve whether a payment to a foreign jurisdiction was "compulsory" and whether the payment was made pursuant to the "authority of a foreign country to levy taxes." In the first case, significant documentation exists regarding whether or not a payment is "compulsory" for purposes of section 901. While a voluntary social contribution would logically seem to fail the compulsory threshold, this issue is often contested in the context of a U.S. taxpayer settling an examination with a foreign taxing jurisdiction.

Consider a situation in which a U.S. taxpayer has filed an income tax return with a foreign jurisdiction claiming a deduction on the basis of some reasonable position, but the deduction is later contested by the foreign taxing authorities. The payment of the additional tax due will not represent an additional expense if a corresponding decrease in U.S. tax results from the U.S. foreign tax credit mechanism. In such a

[1] Unless otherwise noted, all section references are to the 1986 U.S. Internal Revenue Code and the Treasury regulations promulgated thereunder, as currently amended.

[2] The intention of the government is to introduce the new tax as of January 1, 1998.

situation, many taxpayers might be inclined to pay the contested foreign tax rather than incur the cost of challenging the foreign jurisdiction's claim.

However, the U.S. tax authorities could potentially raise the compulsory issue in such a fact pattern, arguing that the payment of the additional tax was not required, since a "reasonable position" existed for the deduction originally. This example is useful to illustrate two different avenues of attack for U.S. authorities on the compulsory issue. The U.S. authorities could attack a foreign levy (in general) as not requiring a mandatory payment (the voluntary social contribution example) or the issue of the compulsory nature of the payment could be raised with respect to a particular taxpayer and a credit could be disallowed for the payment of an otherwise creditable levy.

The U.S. Treasury regulations issued under section 1.901-2(e)(5) provide further examples of noncompulsory payments. These rules provide that a payment is not compulsory if the amount paid exceeds the liability under foreign law. A taxpayer's determination that the payment does not exceed the amount of liability must be based on a reasonable interpretation of foreign law. Furthermore, the taxpayer must exhaust "all effective and practical remedies" to reduce its tax liability.

A second threshold that must be met before a foreign levy can meet the regulatory definition of a tax involves whether the payment was made pursuant to the "authority of a foreign country to levy taxes." The situation in which a taxpayer receives a "specific economic benefit" in exchange for the payment of an amount may be an example of this issue. A specific economic benefit has been defined as a benefit that is not made available on substantially the same terms to substantially all persons who are subject to the income tax imposed in the foreign country.

Accordingly, if a taxpayer receives property, services, or other rights or concessions from the government related to the payment of a "tax," the payment may need to be apportioned between the amount paid to obtain the specific economic benefit provided and the amount that constitutes a "tax" for U.S. foreign tax credit purposes. This rule could operate to disqualify certain taxpayers from a credit in the United States or operate to disqualify a foreign levy in general.

Once qualification as a tax has been established, a tax must be deemed to be in the nature of an income tax under U.S. principles to gain credit eligibility.

Also as a result of this definition of a "tax" for U.S. purposes, fines, penalties, interest, customs duties, and similar items (whether or not related to a qualifying income tax) are not credit-eligible payments in the United States. Once qualification as a tax has been established, a tax must be deemed to be in the nature of an income tax under U.S. principles to gain credit eligibility.

1. Qualification of Tax as an Income Tax

Whether a foreign tax qualifies as an income tax within the meaning of section 901 depends on whether that tax is the substantial equivalent of an "income tax" under the federal income tax laws of the United States.[3] A foreign tax will not be considered to be an income tax in the U.S. sense unless its purpose is to reach net gain and it is structured so as to be almost certain of doing so.[4] According to the U.S. Treasury Department, a foreign tax is likely to reach net gain if and only if the tax satisfies the realization, gross receipts, and net income tests detailed in the regulations.

a. Realization

A foreign tax satisfies the realization requirement if, judged on the basis of its predominant character, it is imposed:

> upon or subsequent to the occurrence of events ('realization events') that would result in the realization of income under the income tax provisions of the Internal Revenue Code.[5]

Under this test, a tax imposed as a result of a basis step-up provision under foreign law may not qualify for a U.S. tax credit due to its lack of a "realization event" under U.S. principles. But note that a tax is evaluated based on how it is generally imposed on taxpayers. As a result, a tax either will or will not meet this test in its entirety. The fact that it may be imposed on some taxpayers who have not experienced a realization event under U.S. principles does not preclude a credit for those taxpayers if the test satisfies the realization event as a whole.

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[3]*See Biddle v. Comm'r,* 302 U.S. 573 (1938).

[4]*See Bank of America Nat'l T.& S. Assn. v. United States,* 459 F.2d 513, 518 (CT. CL. 1972), *cert. denied,* 409 U.S. 949 (1972); *Bank of America Nat'l T.& S. Assn. v. Comm'r,* 61 T.C. 752 (1974); and Rev. Rul. 78-61, 78-1 C.B. 221.

Consider a scenario in which taxpayers randomly elect to pay a foreign "tax" to obtain an increased basis in assets. Assuming this levy qualified as a tax for U.S. purposes under the criteria above, it may nonetheless fail to meet the realization test and may, therefore, not be considered an "income tax" eligible for a U.S. foreign tax credit.[6]

b. Gross Receipts

A foreign tax satisfies the gross receipts requirement if, judged on its predominant character, it is imposed with respect to the gross receipts of an entity or an amount that is not likely to exceed the fair market value (FMV) of services provided by the entity.

Stated differently, the tax must be determined by reference to the actual or deemed cash inflows to the business. A taxable base computed solely by reference to the number of employees of an organization, for example, would not likely meet the gross receipts test. The taxable base need not equal gross receipts for a tax to satisfy this test, but gross receipts should enter into the taxable base calculation (e.g., a tax on net income would satisfy the gross receipts test as it would be calculated by reducing gross receipts by the expenditures of the organization).

c. Net Income

A foreign tax satisfies the net income requirement if the base of the tax is computed by reducing gross receipts to permit either:

- recovery of the significant costs and expenses (including significant capital expenditures) reasonably attributable to such gross receipts; or
- recovery of such significant costs and expenses computed under a method that is likely to produce an amount that approximates, or is greater than, recovery of such significant costs and expenses.

Stated differently, taxpayers should be allowed to deduct an amount that is expected to equal or exceed the amount of costs and expenses that will be incurred in the production of the gross receipts. Notwithstanding this rule, a foreign tax whose base is gross receipts or gross income may satisfy the net income requirement in the:

> rare situation where that tax is almost certain to reach some net gain . . . because costs and expenses will almost never be so high as to offset gross receipts or gross income. . . . [7]

A foreign tax will not be considered to be an income tax in the U.S. sense unless its purpose is to reach net gain and it is structured so as to be almost certain of doing so.

As an example, a tax on gross receipts or gross income will satisfy the net income requirement only when the entities subject to the tax are almost certain not to incur a loss after payment of the tax. As a result of this exception to the normal net income rule, certain foreign taxes on gross dividends, interest, and royalties have been held to qualify as income taxes in the United States sense.[8] Similarly, a foreign tax imposed on the amount of gross wages realized by an employee could be held to meet the test.[9]

II. *Imposta Regionale Sulle Attività Produttive* (IRAP)

A. Computation of IRAP Tax Base[10]

IRAP, as defined by the Italian minister of finance during a hearing on June 11, 1996, is a regional tax with a very large basis of assessment but a reduced proportional rate. The taxable basis will be calculated by applying the so-called "subtraction method" to operating results for the year. As explained further below, the taxable basis of assessment is intended to approximate the difference between the production value and the "typical costs" of the same.

Generally, the financial statement profit for the year plus (1) any deductions claimed for wages, (2) interest expense, including adjusted issue price expenses, (3) extraordinary items, (4) fixed asset and credit devaluation, and (5) certain reserves should approximate the new IRAP taxable base. In detail, the taxable base for commercial and manufacturing companies is expected to be calculated as shown in the table on page 1796.

The determination of the taxable base will be fixed in detail by the decree to be issued by the Italian government. When these rules are released, the modifica-

[5] Treas. reg. section 1.901-2(b)(2). Other qualification criteria are also provided in the regulations for taxes that are imposed on certain "prerealization events."

[6] While beyond the scope of this article, we note that a basis step-up provision could be argued to satisfy this test as a prerealization event.

[7] Treas. reg. section 1.901-2(b)(4)(i).

[8] *See,* for example, Rev. Rul. 73-106, 1973-1 C.B. 343.

[9] *See* Example 3, Treas. reg. section 1.901-2(b)(4)(iv).

[10] The rules discussed herein for the new local tax (IRAP) have been approved by the Council of Ministers but must still be examined by Parliament.

Taxable	Value of production
	gross proceeds
	increase in inventory
	increase in work in progress
Nontaxable	Income from miscellaneous sources
	income from participation in other companies
	income from long-term credits
	income from securities held as fixed assets
	income from securities other than participations
	other income from financial sources
	revaluation of financial assets
	proceeds of an extraordinary nature
Deductible	Costs of production
	cost of raw materials and others
	costs of services
	costs of third-party goods
	depreciation of tangible assets
	depreciation of intangible assets
	decrease of inventory of raw and other materials
	miscellaneous costs
Nondeductible	Other costs
	cost of personnel
	devaluation of assets
	devaluation of receivables
	amounts set aside for funds and reserves
	interest and other financial costs
	devaluation of financial assets
	extraordinary costs

tions to the above general formula for financial and insurance industry taxpayers will become clearer. Generally, financial entities may be required to pay IRAP on the net interest income (if any) of the entity, while insurance industry companies may be charged the new local tax on the difference between premiums collected and damages paid out during a taxable year. Similar to commercial entities, these industries are not expected to receive a deduction of labor costs for IRAP purposes.

Resident and nonresident persons are both liable to IRAP. Nonresidents are taxed only on income from productive activities carried out in Italy through a permanent establishment. Residents are taxed only on income from productive activities carried out in the Italian territory.

The tax rate should be 4.25 percent for the manufacturing industry. However, after two years the regions may increase the rate of the tax by an amount not exceeding 1 percent. It is widely expected that the net proceeds collected by the Italian government under the IRAP regime will approximate the revenues collected under the taxes that are being abolished with the introduction of IRAP.

B. Eligibility of IRAP for U.S. Foreign Tax Credit

Qualification of the new Italian IRAP regime as a "tax" for U.S. purposes should not be problematic. According to the framework provided by the Italian Parliament, the payments would be compulsory and would not have sufficient special application to specific taxpayers and the benefits they receive from the state so as to run afoul of U.S. domestic regulations.

Similarly, the tax should have little difficulty meeting the realization and gross receipts test that are necessary to be classified as an income tax for U.S. purposes. However, the exclusion of wage and interest expense deductions (in addition to the extraordinary and other items listed above) from the IRAP tax base will likely result in a failure to meet the net income test and thus result in the disqualification of the tax for U.S. foreign income tax credit purposes.

The nondeductible expenses are not inherently so slight as to ensure that they will almost never exceed the amount of the gross income. For example, companies experiencing a net loss for the year may very well have significant IRAP tax due. For this reason, a foreign tax that does not permit the deduction of the generally significant expenses incurred in producing that income should be expected to fail to qualify as an "income tax" for U.S. purposes.

Adjustment of the proposed IRAP regime to allow deductions for these amounts is an obvious (and theoretically easy) means to obtain U.S. creditability. A different option may involve the creation of a safe harbor that ensures each taxpayer will be left with a net gain for U.S. purposes. This could be accomplished by providing that the tax due under the IRAP regime may not exceed the net income of the entity prior to computation of the tax. As with

the first theoretical solution, this would have significant consequences on incoming revenues to the Italian treasury and is probably not a viable alternative.

Another possible solution would be to qualify the IRAP as a section 903 "in-lieu-of" tax. Briefly, Treas. reg. section 1.903-1(a)(3) provides that a credit may be claimed for a non-income tax in certain cases in which the taxpayer is subject to that tax rather than to a general income tax of the foreign country.

The IRAP tax is currently proposed as a replacement for, among others, the ILOR income tax. In this scenario (as a replacement, not as a substitute), it may fail to qualify as an in-lieu-of tax. However, opportunities exist if the ILOR regime remains in existence as the general local income tax and IRAP is introduced as a substitute tax for certain taxpayers. It may not be possible to successfully structure this from a U.S. perspective without making changes in the mechanics of the Italian tax, but this may offer a potential solution.[11]

By far the most practical solution involves the ongoing treaty negotiations. If a provision can be inserted into the U.S.-Italy income tax treaty specifying that the IRAP tax will be credit-eligible in the United States, an analysis under U.S. domestic law will not be necessary. The tax will be credit-eligible regardless of its characteristics. This so-called "statement of independent creditability" or treaty override approach has been successfully accomplished in the past.

Consider, for example, the U.K. petroleum revenue tax. As the name implies, this is a revenue, rather than an income, based tax that likely would not be credit-eligible for U.S. purposes based on domestic law. However, article 23, paragraph 1, of the U.S.-U.K. income and capital tax treaty provides as follows:

> For the purposes of applying the United States credit in relation to tax paid to the United Kingdom: the taxes referred to in paragraphs (2)(b) and (3) of Article 2 shall be considered to be income taxes.

The cited paragraph 2(b) of article 2 lists the petroleum revenue tax as a tax covered under the treaty. Accordingly, the U.S. and U.K. treaty negotiators provided for a U.S. credit when the result under a domestic analysis would not be so clear. While we note that the third protocol to the treaty placed further limits on the amount of U.K. petroleum revenue tax that will be allowed as a U.S. foreign tax credit for some taxpayers, this approach can be a very expedient solution to complex technical issues.[12]

If a provision can be inserted into the U.S.-Italy income tax treaty specifying that the IRAP tax will be credit-eligible in the United States, an analysis under U.S. domestic law will not be necessary.

If the U.S. treaty negotiators are willing to agree to extend a credit to a tax that largely replaces ILOR (which was clearly credit-eligible), this represents the simplest and most straight forward solution.[13] We have discussed this approach with the Italian treaty negotiating team and understand the issue was raised during the September meeting in Rome with the U.S. team. Hopefully this proposed solution will prove feasible.

III. Substitute Taxes Under Delegated Decrees

As stated above, Law 662/1996 granted authority to the government to reform many aspects of Italian taxation. An important issue of these new measures is the adoption, in particular cases, of substitute taxes in lieu of income taxes.

It must be pointed out that the steps for implementing the relevant provisions have not been completed yet for all of the following taxes. Some of the following have only been drafted by the government, while others (those referring to the substitute tax on reorganizations) are available in their definitive version and have entered into force.

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[11]Rumors have circulated that one proposal has been submitted that would leave the existing ILOR tax regime in place and either give taxpayers an option as to which regime they are governed under or charge taxpayers the greater of the two liabilities. In addition to failing to satisfy one of the stated aims of the new tax regime (simplification and consolidation of various taxes), this proposal may fail to solve the U.S. credit problem unless very carefully structured. *See,* for example, section 1.901-2(d) on separate levies and section 1.901-2(e)(4) multiple levies. *See also* the U.S. ruling on multiple levies in Rev. Rul. 91-45, 1991-2 C.B. 336 (Mexican asset tax) and the ruling in Rev. Rul. 74-90, 1974-1 C.B. 181, when a tax payment was tied to the amount of another tax.

[12]For additional examples, *see also* the explanatory language regarding the eligibility of the U.K. advance corporation tax for a U.S. foreign tax credit and certain Scandinavian oil and gas taxes.

[13]We also note that this solution would be in line with the provision included in article 44 of the white paper legislative decree, which provides that IRAP will be treated similarly to ILOR by the Italian authorities for treaty purposes.

While each separate substitute tax will eventually need to be analyzed from a U.S. perspective, the following sections provide useful background information on each levy. A few brief comments on the eligibility are offered at the end of the article.

A. Substitute Tax for Purposes of the Equalization Tax

The white paper legislative decree containing the concerned provisions has been submitted to Parliament for examination and, therefore, further modifications may be expected.

Based on this text, the main purpose of the decree is to abrogate the equalization tax now in force and revise the mechanism by which a company distributing profits to its stockholders grants an underlying tax credit on dividends. In this context, as provided for by article 1, a substitute tax is levied on reserves formed of untaxed profits. This tax substitutes the equalization tax which, otherwise, would have been levied to release said reserves. It is imposed on reserves disclosed on statements of the financial year following that in process on December 31, 1996.[14] The tax rate is different depending on the financial year when profits were earned. A 5.6 percent rate applies in case of profits earned starting from the financial year in process on December 31, 1983, and a 2.2 percent rate applies in case of profits earned in financial years prior to that.

As a comment to the above provisions, the following deserves to be highlighted:

- The cited reserves are formed of profits determined under the rules of the Civil Code, that were not taxed when earned due to exemption provisions and that would have required the payment of the equalization tax in case of distribution. Thus, further to the abrogation of the equalization tax, a taxation regime is set forth to release these "pools" of untaxed profits.

- The equalization tax has the same nature as the corporate income tax.

The amount of reserves subject to the substitute tax is reduced by the tax-free allowance disclosed on the income tax return for the financial year following that in process on December 31, 1996. Substitute tax is calculated on the tax return for the financial year following that in process on December 31, 1996, and paid in three installments, each becoming due within the expiration date for the payment of the balance resulting from the said return (9 percent of the liability) and from the following two (50 percent of the liability, for the first and 41 percent for the second). This substitute tax is not deductible for income tax purposes.

> If the U.S. treaty negotiators are willing to agree to extend a credit to a tax that largely replaces ILOR, this represents the simplest and most straight forward solution.

The normal income tax rules will apply for purposes of calculation, assessment, collection, refund, penalties, and litigation of the tax.

B. Substitute Tax on Reorganization Operations

The decree containing the provisions relating to this substitute tax entered into force on November 8, 1997. This decree provides for special rules in case one of the following general transactions is implemented:

- sale of an ongoing concern or qualified participations;

- contribution of an ongoing concern; or

- merger or demerger of companies.

In this context, an elective 27 percent substitute regime has been established to tax the income arising from the above operations. It is payable in equal interest-free installments over a maximum period of five years. The first installment is due with the income tax return for the financial period that includes the date of the transaction; the remaining installments are due within the expiration dates for paying the balance resulting from the returns for the four subsequent tax years. The tax may be offset with income tax credits.

More specifically, the items of income to which this elective 27 percent substitute tax can apply are the following:

- capital gains earned in the course of business activities originating from the sale of assets that constitute a going concern owned for at least three years. If the taxpayer prefers (perhaps due to current-year operating losses or prior-year loss carryforwards), it may include the gain in ordinary income and compute the tax liability in the ordinary manner;

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[14]For example, in case of financial year coinciding with calendar year, the taxable financial year is 1997.

- capital gains earned in the course of business activities originating from the sale of qualified participations, provided these participations have been entered as financial assets in the last three statements. For these purposes, qualified participations are those that grant, at least, 20 percent of the voting stock of the participated company, in case of unlisted stock, or 10 percent of the voting stock in case of listed stock, as under article 2359 of the Civil Code. Also in this case the taxpayer may include the gain in ordinary income and compute the tax liability in the ordinary manner;

- capital gains earned by corporate entities originating from the contribution of a going concern, provided it has been owned for at least three years. Taxpayers will have three options in the future when qualifying appreciated property is contributed to a corporation in exchange for shares:

  (a) Under a free transfer, the corporation receiving the property will retain the historical tax basis of the assets;

  (b) If a taxpayer desires, the transfer may be governed by the old regime which required all inherent gain in the assets transferred to be recognized by the transferor and included in ordinary income subject to the marginal tax rate of the entity. In this case, the transferee corporation receives a fair market value basis in the assets contributed; and

  (c) As a third alternative, a transferor may elect a 27 percent definitive substitute tax to obtain the basis increase for the transferee;

- merger and demerger deficits arising from cancellation of participation or from exchange of shares/quotas. Taxpayers will have two options in the future regarding these transactions:

  (a) If taxpayers desire, the transactions can still be completed in a tax-free manner (the old regime); or

  (b) Taxpayers may elect to restate the assets of the companies involved in the reorganization to FMV by applying the 27 percent substitute tax to all inherent gain.[15]

> If viewed as a separate foreign levy, a substitute tax's qualification as a tax could be questionable depending on how the U.S. authorities interpret the 'compulsory' requirement.

With respect to calculation, assessment, collection, refund, penalties, and litigation, the income tax rules are applicable.

C. Substitute Tax on Capital Gains Realized in the Course of Nonbusiness Activities

The white paper legislative decree containing the provisions relating to this substitute tax has been submitted to Parliament for examination and, therefore, further modifications may be expected.

Based on the text available, the purpose of the decree is to revise the taxation of miscellaneous income and income from capital, including imposition of substitute taxes.

Article 5 prescribes the imposition of a substitute tax on capital gains not earned in the course of business activities by individuals, nonbusiness entities, and nonresident entities with no permanent establishment in Italy.

A 27 percent tax rate applies to capital gains arising from the sale of qualified participations, otherwise a 12.5 percent tax rate applies. For these purposes, qualified participations are those in which:

- voting stock exceeds 2 percent (for listed stock) or 20 percent (for unlisted stock) of the voting rights; or

- capital stock represented by the participation exceeds 5 percent (for listed stock), or 25 percent (for unlisted stock) of the corporate capital.

For these purposes, taxable capital gains are net of possible capital losses. When capital gains, other than those arising from the sale of qualified participations, are realized by nonresident entities, no substitute tax applies provided that an international tax treaty foreseeing an adequate exchange of information between Italy and the country of residence of the recipient is in force. For purposes of determining the residence of the recipient, rules set forth by the tax treaty remain applicable.

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[15]We note that some taxpayers may be able to achieve a FMV basis in the assets with no additional tax cost when sellers or some other party have paid full Italian tax with respect to the gain.

D. Substitute Tax on Income Accrued on Individual Portfolio Management

The same white paper legislative decree concerning the taxation of miscellaneous income and income from capital provides for a substitute tax on income accrued on portfolio investment.

Under article 7, it is prescribed that whenever a taxpayer, not acting in the course of business activities, grants to banking intermediaries qualifying under Law No. 415/1996 a power to manage a portfolio investment, an election for a 12.5 percent substitute tax is allowed. This tax is levied on capital gains, other than those arising from the sale of qualified participations, and on income from capital accrued on the portfolio investment that would otherwise be taxed according to ordinary rules (substitute tax under article 5 on capital gains and withholdings on income from capital) on a cash basis.

The election is to be communicated to the intermediary and covers a one-year period. The taxable basis is determined by the intermediary on an accrual basis as a difference between:

- value of portfolio investment at year-end, gross of substitute tax and withdrawals, net of contributions made during the year; and
- income from capital accrued on the portfolio investment subject to withholdings or, to an exemption regime and the value of portfolio investment at the beginning of the year.

Moreover, this difference is reduced by the amount of expenses relating to the management of portfolio assets. In case a loss is accrued, a four-year carryover is available.

E. Substitute Tax on Income Accrued on Investment Funds

The white paper legislative decree concerning the taxation of miscellaneous income and income from capital provides in article 8 a 12.5 percent substitute tax on income accrued on investment funds existing under the following laws:

It would be unfortunate and counterproductive if these reforms raised significant new barriers for access to Italian markets by U.S.-based investors.

- Law No. 77/1983 (mutual investment funds);
- Law No. 344/1993 (closed-end funds); and
- Law No. 786/1956 (foreign investment funds authorized to be subscribed in Italy).

This tax is levied on income accrued on the said funds at year-end by the company entrusted with the management of the fund, except for the funds existing under Law No. 786/1956 (i.e., foreign investment funds authorized to be subscribed in Italy) when the tax is levied by the subject authorized to promote subscriptions in Italy.

The taxable amount is determined as a difference between:

- net equity value of the fund at year-end, gross of substitute tax, refunds, and profits distributed during the year, and net of subscriptions made during the year; and
- net equity value of the fund at the beginning of the year and profits which are either tax-exempt or subject to definitive withholdings.

In case a loss is accrued, a carryover is available for an unlimited time period.

F. Substitute Tax on Income From Capital Earned Abroad

The white paper legislative decree concerning the taxation of miscellaneous income and income from capital provides under article 12 a substitute tax on income from capital earned abroad. The same provision has recently been inserted into the draft of the 1998 Finance Bill to anticipate its application.

This tax applies to income from capital paid by nonresident subjects to resident subjects (individuals and nonprofit entities) not operating in the course of business activity. These items of income, if paid by resident subjects, would be taxed to these individuals and/or nonprofit entities (not in the course of business activities), with a definitive withholding tax levied by the intermediary involved in the operation. If these items of income are paid by nonresident subjects and no intermediary is involved in the operation, the taxpayer is required to pay the substitute tax reporting calculations on his income tax return. The tax rate applicable is the same as the withholding tax rate that would have been levied, if the payor had been resident in Italy (the measure depends on the specific item of income from capital concerned).

The taxable basis is given by the full amount of interest payments, dividends, or similar items received; no deduction is allowed. This tax is elective; the ordinary regime of income taxation may still be applied.

IV. Qualification of Substitute Taxes for U.S. Foreign Tax Credit

Many issues must be addressed when determining whether payment of the substitute tax will produce a credit for U.S. taxpayers. First, an analysis must be performed to determine whether the tax is a separate levy for U.S. purposes (in which case it must be evaluated based on its predominant character) or whether it is merely a part of an overall Italian income tax (IRPEG or IRPEF), in which case its credit eligibility would be tied to the eligibility of that broader tax.

If viewed as a separate foreign levy, qualification as a tax could be questionable depending on how the U.S. authorities interpret the "compulsory" requirement discussed above. Consider, with respect to the substitute tax on reorganizations, a scenario in which a taxpayer with significant prior-year net operating losses elects, in connection with a corporate reorganization, to pay the 27 percent substitute tax and obtain a fair market value basis in its assets. An argument could be put forth that the elective nature of the substitute tax runs afoul of the U.S. "compulsory" threshold. In our hypothetical example, the taxpayer could have recognized ordinary gain and paid no income tax due to its net operating loss carryforwards or elected to have the transaction governed under the tax-free rules (in which case no basis step-up would have been obtained).

Because the U.S. requirements provide for a foreign levy to be classified as a tax in its entirety, based on its predominant characteristics, the substitute taxes will either qualify as a foreign income tax or it will not for U.S. purposes. The test will not be applied to each individual taxpayer under Treas. reg. section 1.901-2(a).

V. Conclusion

The reforms currently under way in domestic Italian tax legislation are intended to promote increased economic activity within Italy by streamlining certain regulatory and tax obstacles for investors (both foreign and domestic). It would be unfortunate and counterproductive if these reforms raised significant new barriers for access to Italian markets by U.S.-based investors.

Hopefully the U.S. and Italian treaty negotiating teams will recognize how harmful the creation of double taxation can be to both economies and will solve the potential problem by agreeing on a statement of independent creditability in the forthcoming negotiations. Our recommendation has included a specific reference to IRAP and each of the substitute taxes and a provision stating that these levies will be deemed to be income taxes in the United States for purposes of obtaining a U.S. foreign tax credit. ✦

Full Text Citations

- **Italy-U.S.** income tax treaty and protocol, signed April 17, 1984. AccServ & Microfiche: *Doc 93-31276 (87 pages, in English and Italian)*; Electronic: *91 TNI 27-70 (in English)*
- **Italy-U.K.** income tax treaty with notes, signed October 21, 1988. AccServ & Microfiche: *Doc 93-31434 (26 pages, in English)*; Electronic: *93 TNI 95-20 (in English)*

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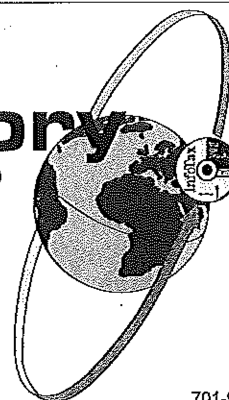

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