INTERNATIONAL

The New Italy–US Tax Treaty

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I. INTRODUCTION

A new treaty between the United States and Italy (hereinafter: the new treaty) was signed in Washington on 25 August 1999 by the Italian Ambassador Ferdinando Salleo and the Deputy Assistant Secretary to US State Department for Western Europe James Gadsen. The new treaty will replace the one signed on 17 April 1984, which has been in force since 30 December 1985. In general, it complies with the OECD Model Convention (hereinafter: OECD Model), although a number of provisions (including the newly introduced anti-abuse rules) are patterned after the 1996 US Model. All references are to the new treaty unless otherwise stated.

The need to negotiate a new treaty resulted from the tax reform adopted by Italy in 1997, which led to the abolition of the Local Income Tax (ILOR) and to the introduction, effective 1 January 1998, of the new Regional Tax on Productive Activities (IRAP). The different criteria applied in each country for the determination of the IRAP taxable base have made it impossible to consider IRAP a direct income tax in the United States (consequently neutralizing any corresponding tax credit in the United States for its residents) for the purposes of the 1984 treaty.

The contracting states did not limit themselves to a clarification on the issue of tax credits deriving from IRAP paid in Italy – to offset taxes due in the United States – but went farther by amending numerous provisions of the 1984 treaty by introducing an anti-abuse regulation in the articles relating to dividends, interest, royalties, and other income and in the "limitation on benefits" (LOB) clause set out in Article 2 of the protocol.

II. SCOPE OF TAXES COVERED AND LIMITATIONS ON US CREDITS

Articles 2 and 23 address the issue of tax credits to be granted against taxes due in the United States in consideration of IRAP paid in Italy.[1] This issue is related to the difficulty in characterizing IRAP as an income tax, a difficulty which arises from the peculiar criteria adopted for determining its taxable base when compared to criteria presently applied in the United States.

Article 2(2)(b) includes IRAP in the various taxes covered. This solution is in line with the interim agreement signed by US and Italian authorities on 31 March 1998. Indeed, because of its peculiarities, for the purposes of the application of the US credit, IRAP is characterized as income tax only to a limited extent.[2]

More specifically, the treaty focused on eliminating the effects which could potentially arise from the non-deductibility – for IRAP purposes – of interest and labour costs. This is one of the major differences in determining the taxable base for IRAP purposes (the taxable base is equal to the net value of production), as compared with standard income taxes (the taxable base which consists of the net income).

In order to neutralize these distortive effects, the new treaty provides for the granting of tax credits in consideration of IRAP only for the part of such tax due in the case where non-deductibility did not exist, determined by applying the coefficient ("applicable ratio") provided for under Article 23(2)(c).

The "applicable ratio" is determined as follows:
- the numerator is the "adjusted" base (equal to the total taxable base upon which the tax is actually levied less the non-deductible labour costs and interest expense); and
- the denominator is the total taxable base upon which the tax is actually levied.

If the "adjusted base" is a negative amount, the numerator is considered to be equal to zero (0), thus neutralizing the value of the "applicable ratio". Therefore, no tax credit will be granted in the United States.

III. CORRELATIVE ADJUSTMENTS, MUTUAL AGREEMENT AND NEW ARBITRATION PROCEDURES

With respect to associated enterprises mentioned in Article 9(2), the new treaty has introduced, with some significant changes, the principle of "correlative adjustments" previously set out in Article 1(7) of the protocol to the 1984 treaty.

This principle – in compliance with Article 25(2) OECD Model – establishes that if a contracting state subjects to taxation profits already taxed in the other contracting state

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1. This issue is particularly important in the case of the United States since US law recognizes – upon fulfilment of specific conditions – tax credits against taxes paid by partially owned Italian companies on profits generating dividends (the "indirect tax credit"). See the Technical Explanation to the 1996 US Model to Art. 23(1).

2. See Art. 23(2)(b), second sentence, which states, "For the purposes of applying the United States credit in relation to tax paid to Italy, the portion of the tax referred to in Para. 2(b)(iii) of Art. 2 (Taxes covered) as described in subparagraph (c) of this paragraph shall be considered to be an income tax".

(as a result of a reassessment at arm's length of the transfer prices adopted between associated companies), that other state will make an appropriate adjustment to the amount of the tax charged on those profits. This rule aims at eliminating any possible double taxation that might arise from adjustments to income of associated enterprises by the tax authorities of the contracting states.

Article 9(2) specifies that, to determine such adjustments, contracting states must take into account the other provisions of the treaty and, in any case, must comply with the mutual agreement procedure[3] under Article 25 OECD Model.

The OECD Model, in Article 25, identifies the following cases as being eligible for application of the mutual agreement procedure:
- measures that result (or will result) in taxation which does not comply with treaty rules;[4]
- the need to settle amicably difficulties or questions relating to the interpretation or application of the treaty; and
- the need to eliminate double taxation in cases which are not specifically provided for by the treaty.

In the new treaty the mutual agreement procedure is available for all of the above cases, while the 1984 treaty covered only the first and second cases.

The authorities of the contracting states have no obligation to resolve the case but merely to *endeavour* to resolve the case. The OECD Commentary allows this restriction and, albeit admitting (on the whole) the usefulness of the mutual agreement procedure in the settlement of double taxation matters, acknowledges that this provision is not the best solution for the taxpayer.[5]

The new treaty aims to resolve – at least partially – the above restriction and provides for the applicability of the arbitration procedure as suggested by the OECD.[6] More specifically, Article 25(5)[7] sets out the possibility of submitting the matter for arbitration when the competent authorities cannot reach an amicable settlement, subject to a prior agreement between the competent authorities and the taxpayer and provided that both parties undertake to respect the arbitration board's decision. The decision of the arbitration board is binding on the taxpayer and the contracting states only with respect to the disputed issue.[8]

The implementation procedures of the arbitration must be further worked out by the contracting states in an exchange of notes through the diplomatic channels and will not take effect until the date specified in the exchange of notes.

This arbitration procedure is undoubtedly a step further in settling double taxation disputes, in that, unlike the mutual agreement procedure, the arbitration board must resolve the case. In any case, arbitration must always be preceded by an attempt to settle the controversy by means of the mutual agreement procedure (for which no time limit has been established) as well as the prior consent by the competent authorities and the specific taxpayer involved.

IV. DIVIDENDS

Compared to the 1984 treaty, the new treaty has abolished the intermediate 10% tax rate and has reduced the ownership threshold required for the application of the 5% reduced rate from 50% to 25% of the voting stock.

The minimum ownership period of 12 months required by the treaty to apply the above reduced rate has remained unchanged.

A. Branch profits tax

Unlike the 1984 treaty, but in line with tax treaties entered into by the United States after the introduction of the US branch profits tax,[9] the new treaty contains the possibility for the contracting states to apply an additional tax, with respect to the other taxes covered by the treaty, to income attributable to the permanent establishment of a corporation resident in the other contracting state in accordance with the conditions and limitations established by Article 10(6).

According to the new treaty,

> a corporation that is a resident of one of the States and that has a permanent establishment in the other State or that is subject to tax in the other State on a net basis on its income that may be taxed in the other State under Article 6 (Income from Immovable Property) or under Paragraph 1 of Article 13 (Capital Gains) may be subject in that other State to a tax in addition to the tax allowable under the other provisions of this Treaty.

Furthermore, the treaty limits the base on which the branch profits tax is applicable:
- to the portion of business income of the foreign corporation that may be attributed to the permanent establishment; or
- to the portion of income subject to tax under Article 6 (Income from Immovable Property) or under Para. 1 of Article 13 (Capital Gains).

For the purposes of the treaty, the tax base consists of:
- the dividend equivalent amount of such profits or income,[10] for the United States; or

3. As to the mutual agreement procedure, see P. Valente, *Convenzioni internazionali contro le doppie imposizioni*, Milan, 1999; P.F. Goris, P.M. Smit, "Court Disregards Mutual Agreement in Treaty with the Netherlands", 37 *European Taxation* 1 (1997), at 20.
4. See K. Vogel, *Double Taxation Conventions*, (Deventer: Kluwer, 1996), at 1667.
5. See Para. 45 of the Commentary to Art. 25 of the OECD Model.
6. At the EU level, Multilateral Convention 436/90/EEC of 23 July 1990 (the Arbitration Convention) – ratified by Italy by Law 99 of 22 March 1993, effective 1 January 1995 – provides an arbitration procedure.
7. See M.P. Bricker, "Arbitration Procedures in Tax Treaties", *Intertax*, 1998, at 104.
8. The United States has also introduced provisions relating to arbitration procedures in its treaties with France, Germany, Mexico, the Netherlands, Canada, Kazakhstan, Ireland and Switzerland.
9. See, for instance, treaties on double taxation entered into by the United States and Austria, Luxembourg and the Netherlands. The United States has, in fact, expressed its reservation on the OECD Model to maintain the possibility to enter into bilateral treaties which acknowledge the right for the United States to apply the branch profits tax on profits earned by foreign companies through permanent establishments. See Para. 83 of the Commentary to Art. 5 OECD Model.
10. According to the Technical Explanation to Para. 8, Art. 10 US Model, "(t)he term 'dividend equivalent amount' used in paragraph 8 has the same

– an amount similar to the dividend equivalent amount, for Italy.

Since Italian tax law does not provide for a tax similar to the US branch profits tax, this provision is presently exclusively applicable to permanent establishments located in the United States. However, Para. 6 of Article 10 has a bilateral function and therefore allows for the potential application of a similar tax to the branch of a US company in Italy, should a similar tax be introduced into Italian domestic law.

Article 1(18) of the protocol derogates specifically from provisions set out by Article 24 on non-discrimination. This article may not therefore be construed as preventing either contracting state from imposing the tax covered by Para. 6 of Article 10 (Branch Profits Tax).

B. Special provisions for governmental entities, regulated investment companies and real estate investment trusts

The new treaty has introduced special provisions concerning dividends distributed to qualified governmental entities or by Regulated Investment Companies (RICs) and Real Investment Trusts (REITs).

Under Para. 8 of Article 10, dividends distributed to a qualified governmental entity that holds, directly or indirectly, 25% of the voting stock of the company paying the dividends, irrespective of the holding period, will be taxed exclusively in the state where the company receiving the dividends is resident, provided the latter is the beneficial owner.

Under Para. 9 of Article 10, dividends distributed by RICs and REITs may also be taxed in the source state, but only at a rate equal to or lower than 15%.[11]

The treaty embodies the provision in the US 1996 Model relating to specific rules for RICs and REITs. These rules aim at preventing shareholders residing in other states from utilizing these entities to obtain unjustified tax savings.

V. INTEREST

Article 11 reduced the interest withholding tax rate from 15% to 10% (as provided by the 1984 treaty).

Article 11 defines interest as:

> income from Government securities, bonds, or debentures, whether or not secured by mortgage and whether or not carrying a right to participate in profits, and debt-claims of every kind as well as all other income assimilated to income from money lent by the taxation law of the State in which the income arises.

Furthermore, Article 11 provides that, in a number of cases, interest can be taxed exclusively in the state where the beneficial owner is resident, with no withholding in the source state.[12]

The innovative aspect, when compared to the 1984 treaty, is the introduction of tax exemption in the source state for interest with respect to sales on credit of goods, merchandise or services. Such an exemption was already considered in the Commentary to the OECD Model. Furthermore, the treatment provided for by this rule does not differ from Italian domestic provisions, which establish that interest on delayed payments and interest for sales on credit are subject to the same taxation regime as the income from which credits giving rise to such interest derive. Such interest is therefore taxable in Italy only if it is received through a branch located there, while it is exempt from taxation in all other cases.

VI. ROYALTIES

The new treaty has also introduced some significant changes with respect to the taxation of royalties.[13]

Article 12 of the 1984 treaty established three different tax rates:

– royalties paid in connection with payments of any kind received as consideration for the use of, or the right to use, any copyright on literary, artistic or scientific work: 5% rate;
– royalties paid in connection with payments of any kind received as consideration for the use of, or the right to use, motion pictures or films, tapes or other means of reproduction used for radio or television broadcasting: 8% rate; and

meaning that it has under Section 884 of the Code, as amended from time to time, provided the amendments are consistent with the purpose of the branch profits tax. Generally the dividend equivalent amount for a particular year is the income described above that is included in the corporation's effectively connected earnings and profits for that year, after payment of the corporate tax under Articles 6, 7 or 13, reduced for any increase in the branch's U.S. net equity during the year and increased for any reduction in its U.S. net equity during the year. U.S. net equity is U.S. assets less U.S. liabilities. See Treas. Reg. Section 1.884-1. The dividend equivalent amount for any year approximates the dividend that a U.S. branch office would have paid during the year if the branch had been operated as a separate U.S. subsidiary company. In the case that the other contracting state also imposes a branch profits tax, the base of its tax must be limited to an amount that is analogous to the dividend equivalent amount."

11. The reduced rate is applicable to REITs only if the following conditions are met:

> "a) the beneficial owner of the dividends is an individual holding an interest of not more than 10 percent in the REIT;
> b) the dividends are paid with respect to a class of stock that is publicly traded and the beneficial owner of the dividends is a person holding an interest of not more than 5 percent of any class of the REIT's stock;
> c) the beneficial owner of the dividends is a person holding an interest of not more than 10 percent in the REIT and the REIT is diversified".

12. This provision applies if "the interest is beneficially owned by a resident of the other contracting State that is a qualified governmental entity that holds, directly or indirectly, less than 25 percent of the capital of the person paying the interest; the interest is paid with respect to debt obligations guaranteed or insured by a qualified governmental entity of that contracting State or the other contracting State and is beneficially owned by a resident of the other contracting State; the interest is paid or accrued with respect to a sale on credit of goods, merchandise, or services provided by one enterprise to another enterprise; or the interest is paid or accrued in connection with the sale on credit of industrial, commercial, or scientific equipment".

13. See K. Vogel, *supra* note 4, at 765; F.C. de Hosson, "Taxation of cross-border software payments" (Article 12), *Intertax*, 12/1992, at 683; P. Valente, *supra* note 3; Sprague and Chesler, "Comments on the Commentary to Art. 12 (royalties) of the 1992 OECD Model Treaty", *Intertax*, 1993, at 311; H. J. Ault, "Treatment of Computer Software", 33 *European Taxation* 10 (1993), at 330; A. Baumgarten, R.A. Gorman-Schwartz, "Copyright Law and Certain Tax Treatment of Software Transactions", 49 *Bulletin for International Fiscal Documentation* 11 (1995), at 522.

– royalties paid in connection with all other cases: 10% rate.

Furthermore, Article 10(1) provided for a 7% tax rate on royalties paid in connection with tangible personal property.

The new treaty provides for the exclusive taxation in the state where the recipient is resident, and the consequent exemption from withholding taxes at source, if the recipient is the beneficial owner of royalties paid for the use of, or right to use, copyrights on literary, artistic or scientific work.

The treaty also rules that a withholding tax of 5% in the case of royalties paid for the use of, or the right to use, computer software or industrial, commercial, or scientific equipment, which previously did not form a separate category, must be applied.

The withholding tax rate set out in the treaty in all other cases is equal to 8%.

VII. ANTI-TREATY SHOPPING PROVISIONS

A. In general

The anti-abuse clauses on dividends, interest, royalties and other income contained in Articles 10, 11, 12 and 2 will be examined in this section.

All of the above rules establish that the provisions to which they refer are not applicable if the main purpose or one of the main purposes of any person, concerned with the issue or assignment of the shares, debt-claims or other rights in respect of which interest, dividends, royalties or other income is paid, was to take advantage of these articles by means of that issue or assignment.

The above clauses are based on the "substance-over-form principle", according to which benefits of the treaty do not apply when it is proven that the formal appearance (for instance, income earned by a person of one contracting state) is not consistent with the "economic substance" of the operation and that this appearance is adopted for the sole or main purpose of taking advantage of benefits which may be obtained from treaty rules.

Furthermore, these provisions are one of the possible applications of the "bona fide business purpose", according to which the operation entailing the application of the treaty must have a sound business purpose that justifies the existence of a company residing in one of the contracting states.[14]

B. "Limitation on benefits" (LOB) clause (Article 2 of the protocol)

1. Purpose and structure of the LOB clause

Article 2 of the protocol to the new treaty contains an explicit LOB clause which aims at preventing persons not residing in either contracting state from establishing structures or investing in one of the contracting states with the main purpose of benefiting from treaty provisions ("treaty shopping").[15] This objective is attained by excluding from the application of some or all the treaty benefits all persons who did not pass the required tests in order to prove that their residence in one of the contracting states was solely established for the purpose of obtaining treaty benefits. The purpose of each test under the LOB clause is, thus, to establish whether an actual link exists between the person intending to benefit from treaty rules and the contracting state of residence.

As confirmed by the interpretation of the US tax authorities in the Technical Explanation to treaties entered into by the United States, application of the LOB clause is complementary to application of anti-abuse provisions set out in each country's domestic law, such as provisions based on the principles of "business purpose" and "substance-over-form".[16]

The 1984 treaty, currently in force, also contains (in its protocol) an LOB clause similar in structure to the one included in the new treaty.

The 1984 treaty clause stems directly from Article 16 of the 1981 US Model and is consistent with that Model, notwithstanding its more limited scope.

Article 2 of the protocol to the 1984 treaty, in fact, only applies to persons (other than individuals) residing in one of the contracting states and solely in connection with specific income categories, and in particular those governed by Article 7 (Business Profits), Article 10 (Dividends), Article 11 (Interest), Article 12 (Royalties), Article 13 (Capital Gains) and Article 22 (Other Income).

The tests provided for in Article 2 of the protocol to the 1984 treaty – in view of the second paragraph of that article – only apply if the competent authority of a contracting state ascertains that the establishment, acquisition or maintenance of a specific person, as well as the carrying on of its activity, serves the main purpose of taking advantage of treaty benefits.

The tests provided for by the LOB clause of the 1984 treaty are applicable provided that the competent authorities of the contracting states carried out a preliminary evaluation as to the purpose pursued in connection with the benefits of the treaty.

The 1984 treaty tests (Article 2(1) of the protocol) in the case of companies may be summarized as follows:

14. This principle is also found in Para. 21 of the Commentary to Art. 1 OECD Model.

15. See the US Treasury's Technical Explanation to Art. 22 of the 1996 US Model. The terms "treaty shopping" and "tax treaty abuse" "refer to the practice of some investors of 'borrowing' a tax treaty by forming an entity (usually a corporation) in a country having a favourable tax treaty with the country of source" (Rosenbloom, "Derivative benefits: Emerging U.S. treaty policy" in *Essays on International Taxation*, (Deventer: Kluwer, 1993), at 335). See further, Becker and Thömmes, "Treaty shopping and EC law", 31 *European Taxation* 6 (1991), at 173; V. Uckmar, "General Report, Tax avoidance/tax evasion" in *Cahier de Droit Fiscal International*, Vol. LXVIII, 1983, at 15; V. Uckmar, "I trattati internazionali in materia tributaria" in *Trattato di diritto tributario*, edited by A. Amatucci, 1994, at 754; K. Vogel, *supra* note 4, at 50-58 and 454-459; S. van Weeghel, *The improper use of tax treaties*, (Deventer: Kluwer, 1998), at 119; "Treaty shopping: principi e limiti", *Commercio Internazionale*, 19/1996, at 853; P. Valente, "Elusione fiscale internazionale: strumenti unilaterali di contrasto e disposizioni convenzionali in materia di treaty shopping", *Diritto e Pratica Tributaria* 1998, III, at 11.

16. See the US Treasury's Technical Explanation to Art. 22 of the 1996 US Model.

- "ownership test": more than 50% of the company is required to be held directly or indirectly by one or more individuals residing in one of the contracting states, US citizens, the United States, or publicly traded companies residing in one of the contracting states; and
- "publicly traded test": if the company is publicly traded, its main class of shares must be substantially and regularly traded on one of the recognized stock exchanges.[17]

2. General terms and conditions (Article 2(2) of the protocol)

Article 2 of the protocol to the new treaty is structured similarly to the 1996 US Model and follows the same pattern adopted for other recent treaties entered into by the United States.

Treaty benefits are strictly subject to the passing of at least one of the tests under Article 2(2) of the protocol.

In particular, a resident of one of the contracting states is entitled to take advantage of the benefits of the treaty only if the resident is:
(a) an individual;
(b) a qualified governmental entity;
(c) a company complying with the "publicly traded test", or "subsidiary of publicly traded test";
(d) a non-profit organization;
(e) a pension fund; or
(f) a person, other than an individual, that satisfies the "ownership test" and the "base erosion test".

With reference to the condition in letter (a), the LOB clause does not limit the application of the treaty to resident individuals. No limitation is set for qualified governmental entities (letter (b)).

The first test required by the LOB clause for companies resident in a contracting state is the "publicly traded test". It states that all shares in the class or classes of shares representing more than 50% of the voting rights and value of the company have to be traded on a recognized stock exchange. This test applies to all company shares when the company has only one class of shares or to all the shares of the main class of shares, i.e. of the class of shares representing more than 50% of the voting power and value of the company when the latter disposes of several classes of shares.[18]

The following test, under Article 2(2)(c)(ii), is the "subsidiary of publicly traded test". To comply with this, a company is required to be held by other publicly traded companies, regularly traded on a recognized stock exchange and resident of one of the two contracting states. More specifically, at least 50% of each class of shares of the company must be held, directly or indirectly, by five or fewer companies which are entitled to benefit from the treaty[19] under the above-mentioned publicly traded test. If the publicly traded company has indirect ownership of the tested company, each intermediate owner in the participation chain is required to be eligible for the treaty benefits, in accordance with the provisions of Paragraph 2.

The Technical Explanation to the 1996 US Model specifies that the subsidiary of the publicly traded test is a result of the combination of the "publicly traded" criteria and the "ownership" criteria, in that, in addition to the requirement for owners to be publicly traded, a minimum ownership of each class of shares equal to, or higher than, 50%, is required.

In light of the above, the "subsidiary of publicly traded test" only applies to those cases where intermediate owners of the resident company (traced back along the ownership chain up to the publicly traded company) are residents of one of the contracting states and comply with at least one LOB clause test. This entails that the subsidiary of publicly traded test is not applicable, for example, to groups whose publicly traded parent companies (resident of one of the contracting states) indirectly own a company resident of the other contracting state through one or more intermediate companies located in third countries.

Letters (d) and (e) of Para. 2 grant treaty benefits to non-profit organizations, exempt from tax and residents of one of the contracting states (under Article 1(5)(a)(i) of the protocol) and pension funds (under Article 1(5)(a)(ii) of the protocol), provided that more than 50% of the recipients, partners, or owners are individuals residing in one of the contracting states.

Finally, letter (f) of Para. 2 establishes a test for persons that do not fall under any of the categories reviewed so far.

The test in letter (f) consists of two conditions which must be met at the same time: the "ownership test" and the "base erosion test". To meet the "ownership test", persons complying with one of the tests reviewed so far must own directly or indirectly at least 50% of each class of shares or other beneficial interest in the person for at least half the days of the taxable year.

17. For the purposes of the provisions commented on here, "recognized stock exchanges" are defined at Art. 2(3), which mentions: the NASDAQ system, stock exchanges registered with the Securities and Exchange Commission, stock exchanges established and organized under the laws of Italy and any other stock exchange mutually recognized by the competent authorities of the contracting states.

18. Since the treaty does not define the concept of "regularly traded", this concept must be interpreted in light of the contracting states' domestic law. As provided for by Art. 3(2), "As regards the application of this Treaty by a contracting state any term not defined therein shall, unless the context otherwise requires, have the meaning which it has under the laws of that state concerning the taxes to which this Treaty applies".
The attempt to define the term "regularly traded" may entail serious interpretation related problems, notably in connection with Italian law, which provides no anti-abuse rule similar to the LOB clause. Conversely, US law contains a number of references relating to the terms utilized in the LOB clause.
As specified by the Technical Explanation to the 1996 US Model, the expression "regularly traded" may be defined by adopting the US Treasury Regulations Sec. 1.884 (d)(4)(i)(B), on the branch profits tax.
According to such a definition, a class of shares is deemed as regularly traded if:
- "*de minimis* trading" has occurred for at least 60 days during the tax period; and
- the total number of shares negotiated during the year is equal to no less than 10% of the average number of shares circulating in the same period.

The term "recognized stock exchange" is defined in Para. 5 of the LOB clause and coincides with the one included in the 1984 treaty (see above).
Moreover, the above definition is different from the one provided by Art. 22(5) 1996 US Model, which does not include the stock exchanges mutually recognized by the competent authorities of the contracting states.

19. The maximum number of publicly traded participating companies (five) is not specified by the LOB provisions of Art. 22(2)(c)(ii) US Model.

To pass this test, it is also its necessary that, in the case of indirect ownership, each intermediate owner meet at least one of the conditions in Para. 2.

The "base erosion" test provides that less than 50% of the person's gross income for the taxable year must be paid or accrued, directly or indirectly, to persons who are not residents of either contracting state in the form of payments that are deductible for income tax purposes in the person's state of residence. For the application of the "base erosion test", payments attributable to permanent establishments of the person located in the other state are not taken into account.

3. Alternative conditions for each income category (Article 2(3) of the protocol)

Para. 3 of the LOB clause establishes that if a resident of one of the contracting states does not pass any of the tests under Para. 2 the "active trade or business test" must be applied with respect to specific items of income derived from the other state. This test requires that the persons provide evidence that they carry on a business or trading activity in the state of residence so that the item of income derived in the other state is connected or ancillary to such activity.

More specifically, according to this test, residents of one of the contracting states, who otherwise would not have been eligible for the benefits of the treaty, are entitled to benefit from the provisions relating to single items of income if they meet the following conditions:

- the resident is engaged in the active conduct of a trade or business in his own state of residence;
- the income is connected with or incidental to the trade or business; and
- the trade or business is substantial in relation to the income-generating activity carried on in the other state.

The above conditions must be ascertained in connection with each item of income derived from the other state. It is therefore possible that a person may benefit from the provisions of the treaty relating to specific items.[20]

4. Discretionary benefits and "treaty ruling"

Para. 4, Article 2 sets out a discretionary procedure for the granting of treaty benefits. According to this procedure, a resident of a contracting state who does not meet the requirements of any of the tests, may, nonetheless, be granted benefits of the treaty if the competent authority of the state granting the claimed benefits acknowledges, at its own discretion, the applicability of the treaty.

This provision was introduced with the intent of allowing companies devoid of the features required to pass the LOB clause tests to nevertheless be entitled to treaty benefits.

The outcome of the discretionary procedure is subject to the decision of the competent authorities who may acknowledge a partial or total application of the treaty benefits and who may also decide to establish a time limit for the utilization of these benefits.

20. The wording of Para. 3 defines the following conditions for the application of the test:

- the conduct of an active trade or business carried out by the person in the state of residence does not include the business of making or managing investments, unless this activity includes banking, insurance or securities traded by a bank, insurance or registered security dealer;
- whether a trade or business is substantial will be determined on the basis of all the facts and circumstances. In any case, a "safe harbour rule" is set out, i.e. a series of assumptions according to which, if the asset value, the gross income, and the payroll expense relating to the activity carried on in the state of residence are equal to a specific percentage (7.5% of each of the three indicators above and 10% of the average value) of the value of such indicators which relate to the activity generating income in the other state, it is assumed that the substantiality requirement is met;
- the type of income is assumed to be related to the trade or business activity if the activity carried on in the other state generating income is a line of business that forms a part of or is complementary to the trade or business; or
- income is deemed incidental to a trade or business if it facilitates the conduct of the trade or business in the other state.

TABLE 1 – Calculation of IRAP creditable against US income tax

The creditable tax may be determined on the basis of the following formulas:

IRAP tax credit = applicable ratio x gross IRAP due

The "applicable ratio" is calculated as follows:

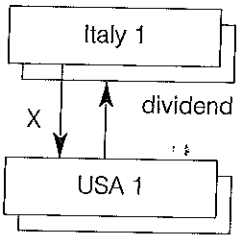
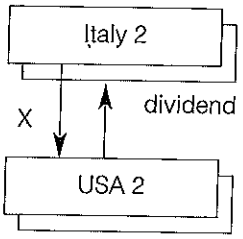
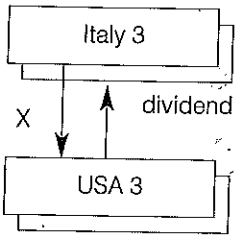
$$\text{applicable ratio} = \frac{\text{adjusted base}}{\text{total tax base}}$$

The adjusted tax base is equal to the following difference, if positive:

adjusted base = total tax base – non-deductible interest expense and labour expense

If the adjusted taxable base is a negative amount, no tax credit is granted to the taxpayer.

TABLE 2 – Taxation regime applicable to US dividends distributed to Italian corporate shareholders

			
	0% < X < 20%	20% < X < 25%	X > 25%
withholding tax	15%	15%	5%[1]
dividend treatment in Italy	100% taxable	60% exempt	60% exempt
effective rate gross of the foreign tax credit	37%	14.8%	14.8%

X = ownership percentage of voting rights

1. The 5% withholding tax applies if the recipient has owned at least 25% of the voting stock of the company distributing the dividends for at least a 12-month period ending on the date the dividend is declared.

TABLE 3 – Tax burden on US dividends distributed to Italian corporate shareholders

	0 < X < 20	20 < X < 25	X > 25
gross dividend	100.0	100.0	100.0
withholding	(15.0)	(15.0)	(5.0)
net distributable dividend	85.0	85.0	95.0
gross Italian tax	(37.0)	(14.8)	(14.8)
foreign tax credit	15.0	6.0	2.0
net tax	37.0	23.8	17.8
net income	63.0	76.2	82.2