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Global Tax Alert

Italian tax authorities assess foreign financial institutions regarding loans to Italian individual clients

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Background

The Italian tax authorities (ITA) are serving tax questionnaires to foreign financial institutions[1] aimed at identifying cases where they:

(i) Have issued loans directly (i.e., loans issued directly by the foreign financial institutions without involvement of their Italian branches or subsidiaries) to Italian individual clients

(ii) Have utilized Italian agents to provide services to their clients in Italy

The ITA has clarified[2] that Italian source capital income, such as interest, earned by nonresident entities is taxable in Italy according to local tax provisions and may benefit from the reduced interest withholding tax rate provided by the relevant Tax Treaty, if applicable.

Considering the data collected from past Voluntary Disclosures Programs and the Common Reporting Standard, the ITA are now committed to assess foreign financial institutions that may have failed to comply with local tax and regulatory provisions relevant for loans issued directly to Italian individual clients.

Possible tax challenges

With reference to: **(i) the issuing of loans directly to Italian individual clients**, foreign financial institutions may have failed to comply with their duty to file the local corporate income tax (IRES) return and to pay the relevant tax on interest earned from such clients.

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The ITA may assess the omission to file an IRES tax return starting from fiscal year (FY)13 onwards, asking for the payment of the relevant IRES (at the internal full IRES rate[3]) plus interest and penalties. Penalties may range from 120% to 240% of the tax due and may even be regarded as a tax crime with additional criminal penalties.

With reference to: **(ii) the utilization of Italian agents to provide services directly to clients in Italy**, the ITA or the Italian Tax Police (ITP) may start a deeper investigation on how Italian agents carried out their activities in Italy on the behalf of the foreign financial institution. If such agents did not act in the ordinary course of business that was carried on independently in Italy, and such agents habitually concluded contracts in Italy in the name of the foreign financial institution, then the latter may be challenged for carrying out business in Italy through a hidden permanent establishment (PE).[4]

In this case, the ITA may assess the omission to file an IRES tax return starting from FY13 onwards with the same implications described with reference to (i) above.

Potential tax criminal implications

In the case of a hidden PE in Italy of a foreign legal entity, the Public Prosecutor's Office may charge the crime of **omitted tax return** (art. 5[5] of Legislative Decree No. 74/2000) against either the legal representative or the board of directors of the foreign legal entity that for each of the relevant FYs did not file the IRES tax return, if the alleged tax evaded is more than €50,000 per FY.

Further possible criminal and regulatory implications

European Union (EU) or extra-EU banks that provide (or have provided) financing in Italy without a proper license or passport may receive regulatory sanctions by the Italian banking surveillance Authority. The provision of banking services by extra-EU credit institutions that are not authorized by the Bank of Italy may be considered a crime under Title VII of the Italian legislative decree no. 385/1993.

Additional consequences may arise from a civil law standpoint, since loan agreements provided in Italy *vis-à-vis* Italian clients shall comply with a number of mandatory provisions (e.g., usury, banking transparency).

As such, foreign credit institutions must carefully assess (also through the adoption of internal procedures) how they approach or solicit their products to Italian clients and prospects. Similarly, when such credit institutions provide banking services in Italy from their headquarters and/or through their Italian branches, they must clearly regulate and identify how they are operating in Italy.

Finally, foreign credit institutions that have or intend to have a business relationship with Italian agents must comply with the Italian legal and regulatory framework.

EY Italy's (MED and FSO) Tax and Legal department has significant experience in working with foreign financial institutions to address these types of tax reviews and assessments.

Endnotes

1. Particularly in Switzerland and Monaco, but cases have also been reported for Ireland and other European jurisdictions.
2. Resolution No. 89/E issued on 25 September 2012 and by Response No. 41 issued on 23 October 2018 ITA.
3. FY13: 27.5% + 8.5% (overall 36%); FY14: 27.5%; FY15: 27.5%; FY16: 27.5%; FY17 24% + 3.5% (overall 27.5%); FY18: 24% + 3.5% (overall 27.5%).
4. Effective 1 January 2018, Italy's 2018 Budget Law (Law No. 205 of 27 December 2017) significantly amended the domestic definition of PE and implemented certain Organisation for Economic Co-operation and Development (OECD) guidelines set forth under Base Erosion and Profit Shifting (BEPS) Action 1 (Addressing the Tax Challenges of the Digital Economy) and Action 7 (Preventing the Artificial Avoidance of PE Status). The law revised the definitions of both the "Fixed Place PE" and the "Agency PE," by amending the text of Article 162 of the Italian Income Tax Code (IITC). **Prior to the 2018 Budget Law**, the definition of PE for Italian income tax purposes – contained in Article 162 of IITC – was modelled on the current OECD Model Tax Convention definition. Regarding the Fixed Place PE, the main changes are: (i) the introduction of a new item in the list of cases that are presumed to constitute a Fixed Place PE; (ii) the modification of the specific activity exemption; (iii) the repeal of Art. 162 (5) of the IITC regarding electronic equipment; and (iv) the introduction of an anti-fragmentation rule. The Agency PE rules were changed in compliance with BEPS Action 7 recommendations concerning commissionaire arrangements. Ultimately, these changes to the Agency PE definition may not have a material impact on Italian business and administrative practices, since **existing Italian case law contains a broad interpretation of the Agency PE concept**. The most relevant judicial case is *Phillip Morris* (Supreme Court judgments 3367, 3368, and 3369 of 7 March 2002; 431926 of 26 March 2002; 7682 and 7689 of 25 May 2002; 10925 of 22 September 2002; and 17373 of 6 December 2002) where the Supreme Court affirmed, *inter alia*, the following principles:
   - The participation of officers or representatives of an Italian company in phases of the negotiation or conclusion of contracts on behalf of a related company abroad constituted an Agency PE even if it was not granted a formal power of representation.
   - A national structure carrying on management of business transactions for the benefit of a nonresident company should be deemed to constitute a PE in Italy, even though only one area of the nonresident's business was managed by the domestic structure.
   - Factors indicating the existence of a PE in Italy, including dependence and the authority to conclude contracts, should be assessed on the basis of the substance rather than exclusively on the basis of the mere legal form of the business transactions.
   - A company situated in Italy may be deemed to be a PE of multiple foreign companies within the same group that pursue a common business strategy. In such instances, the nature of the activities performed in Italy will be assessed in light of the common business strategy of the group.
   - Group companies that are subject to a unified strategy aimed at maximizing Italian profits for all nonresident companies involved have an Agency PE in Italy, and it is misleading to consider each fragment of the strategy separately.

   As a reaction to this interpretation, the OECD amended the Commentary on Article 5 in 2005; however, Italian representatives at the OECD inserted the following observation, *Italy wishes to clarify that, with respect to paragraphs 33, 41, 41.1 and 42, its jurisprudence is not to be ignored in the interpretation of cases falling in the above paragraphs …* Therefore, **notwithstanding the fact that under Italian income tax law and constitutional law tax treaty provisions take precedence over Italian domestic provisions when they are more favorable to the taxpayer, Italian judicial interpretations of Agency PE override tax treaty provisions on a *de facto* basis**.
5. Which provides for imprisonment from one year and six months to four years, under certain circumstances.

For additional information with respect to this Alert, please contact the following:

Studio Legale Tributario, MED and FSO Tax Controversy, Milan
- Maria Antonietta Biscozzi maria-antonietta.biscozzi@it.ey.com
- Alberto Giorgi alberto.giorgi@it.ey.com

Studio Legale Tributario, FSO Tax, Milan
- Giuseppe Marco Ragusa marco.ragusa@it.ey.com

Studio Legale Tributario, FSO Legal, Milan
- Davide Nervegna davide.nervegna@it.ey.com
- Stefano Torregiani stefano.torregiani@it.ey.com

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