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SPECIAL ISSUE: TAX INVERSION UNDER ITALIAN AND U.S. REGULATIONS.

Abstract

“Esterovestizione” – a.k.a. “tax inversion” or “corporate expatriation” is the practice of moving a domestic parent company to a foreign jurisdiction with a lower tax regime. The goal is to obtain tax savings even if the business operations may remain unchanged. Notwithstanding being lawful from a corporate perspective, tax authorities scrutinize this practice and its consequences.

Tax inversion under Italian regulation.¹

Under Italian law (Italian Tax Code, T.U.I.R., Section 5(3)) a company is considered having its residence in Italy, if for more than 6 months, its legal seat, the management activity, or its business operations are conducted in Italy. With Law Decree No. 223 of July 4, 2006, converted into Law No. 248/2006, Italy has adopted legislative measures geared toward the avoidance of the corporate inversion practice. Accordingly, moving a parent company’s tax

residence abroad does not shield from the application of Italian income tax as later confirmed in 2015 by the Italian Supreme Court.²

Under article 73, paragraphs 1 - *5bis* of the T.U.I.R., a foreign company may be subject to Italian income tax if it maintains in Italy a registered office, an administrative office, the primary business activity, or the company’s governing documents.

Foreign income may be subject to Italian taxation when, "unless proven otherwise,"³ the foreign company is "controlled, even indirectly, [. . .] by a person residing in [Italy]" or is “managed [by] a board of directors, or other equivalent management body, composed mainly of directors residing in [Italy].”⁴

In order to prove corporate inversion, Italian tax authority looks for “factual evidence”⁵ supporting the presumption of intent to avoid the payment of taxes. Evidences include holding or performing any of the following activities in Italy: the drafting and/or executing of the company minutes, the meeting of company executives; the residences of key managers; the occurring of the general shareholders meeting; the location of the corporate books; the and location of the company’s major financial activities, as confirmed in several precedents by the Italian Supreme Court.⁶

¹ Italian case law and regulations have been translated by the authors.

²See: Supreme Civil Court no.8196, March 22,2015: "The residence abroad (in this case in the USA) of a company [Agriamerica Corporation] does not exclude the possibility that it may be resident in Italy for tax purposes whenever the Tax Administration demonstrates that the commercial activity has been run by an individual seating in Italy and that the relevant corporate activities - the minutes of the meeting of the Board of Directors and the minutes of the annual meeting of the shareholders - have been prepared in Italy. Consequently, for tax purposes the

US company must be considered Italian resident and the foreign income must be considered Italian income, without any permanent establishment abroad of the same being found when it has been demonstrated that there is not a firm center of activity in presence of a warehouse for the marketing and shipping of the goods sold."

³ Article 73 paragraph *5bis* T.U.I.R.

⁴ *Id.*

⁵ Circolare Agenzia delle Entrate No. 28 / E – 2006, at. 25.

⁶ See: Supreme Civil Court No. 33234/12.21.2018, at. 5.



U.S. Tax framework.

Preliminarily, a short background of corporate taxation in the U.S.

The U.S. corporate tax treatment depends on the company’s legal structure (partnership, LLC, or corporation), and (largely) on the applicable local, state, and federal tax laws of the jurisdiction in which the company operates.

Partnership, LLC, or corporation.

A partnership exists when two or more individuals/entities decide to conduct business with the intent to share profits and losses. Each partner is personally liable for the business operations and for losses and profits.

For tax purposes, a partnership is a not taxable entity: income is taxed directly to partners according to their shares of profits/losses and/or other agreement in place.

An LLC is a legal entity that benefits of the limited liability status with third parties and whose owners are called members.

From a tax perspective, the LLC is a pass-through entity (treated for tax purposes as a partnership) and does not pay income taxes unless it elects to be taxed as a corporation.

However, profits are reported to the members who will have to report and pay for with their personal tax returns.

If the LLC choses to be treated as a corporation for tax purposes, this election is irreversible and

will results in tax consequences similar to a corporation.

A corporation is a legal entity with one or more shareholders and limited liability.

For federal tax purposes, a U.S. corporation must file a corporate income tax return filing Form 1120. It must report all income, gains, losses, deductions, and credits.⁷

For tax years beginning on December 31, 2017, the Tax Cuts and Jobs Act (TCJA, P.L. 115-97) replaced the graduated corporate tax rates with a flat 21% tax rate on corporation’s net income⁸. A second level of taxation is imposed on the corporate shareholders when (or if) the corporation’s after-tax income is distributed to shareholders. Shareholder income is included in his/her tax return and taxed at the applicable rates. With the TCJA, the US systems from the worldwide principle of taxation shifted towards the territorial one.

Tax inversion in the U.S.

A tax inversion is a transaction where a US firm reorganizes its corporate and ownership structure so that the US holding company becomes a foreign holding corporation and loses its U.S. residence and holding status, with the

⁷ Source IRS: <https://www.irs.gov/pub/irs-pdf/i1120.pdf>.

⁸ *Net income* means *gross income* less all *deductible expenses*. *Gross income* is: “all income whatever source derived”, such as: business profits, dividends, interest, rents and royalties (26 U.S.C. § 162). *Deductible expenses* are “all ordinary and necessary expenses incurred during the taxable year” associated

with the taxpayer’s business or investments activities” (26 U.S.C. § 212). Deduction is not allowed for personal, living or familiar expenses (26 U.S.C. § 262).

⁸ See Article 10 of the Tax Treaty for the Avoidance of Double Taxation between Italy and the U.S. (1999).



intent to reduce the applicable U.S. taxation level.⁹

In 2004, the American Job Creation Act (JOBS Act) established that if the original US shareholder still owned 80% of the new foreign entity, it could not claim any benefit of the tax inversion.

The JOBS Act allowed two inversion procedures: (a) The creation of a foreign subsidiary conducting substantial business activity; or (b) The combination of a domestic corporation with a foreign counterpart – a.k.a. a merger (with ownership between 80% and 60%, where ownership at or above 80% implies that the inversion is disregarded, and ownership below 60% is ignored for tax purposes).

(a) Substantial business activity

In this form of inversion, a U.S. corporation and foreign subsidiary exchange stock, resulting in each entity owning some of the other’s stock. As a result, the new entity is a foreign corporation with a U.S. subsidiary. The exchange is generally based on companies’ valuation, and for tax purpose, the deal is referred to as a naked inversion. Treasury Regulation 9592 of June 12, 2012 increased the threshold of business activity test from 10% to 25%.¹⁰

(b) Merger

A form of inversion relevant for tax purposes occurs when a U.S. corporation merges with a smaller foreign corporation with the U.S. shareholders owning a majority stock of the target. As a result, the US shareholders have the control of the foreign corporation.

⁹Source: https://www.irs.gov/pub/int_practice_units/isocup_1_10_01.pdf, page 3.

¹⁰ Available at https://www.irs.gov/irb/2012-28_IRB#TD-9592

Tax treatment of U.S. tax inversion.

Tax consequences are governed by 26 USC § 7874 which has the purpose of reducing the incentives for planning a tax inversion. Under this rule, corporate inversions are referred to as: (1) “80% inversions” and (2) “60% inversions”.

(1) 80% inversion¹¹

An 80% inversion occurs when, after the transaction, the U.S. corporation owns at least 80 percent (vote or value) of the stock of the acquired target and the acquired target does not have substantial business activities in the foreign country of incorporation.

For U.S. tax purposes, the new foreign target is treated as a U.S. domestic corporation and is taxed in the U.S. on its income.

(2) 60% inversion¹²

A 60% inversion occurs when, after the transaction, the U.S. corporation holds at least 60%, but less than 80% (by vote or value) of the stock of the acquired target and the acquired target conducts substantial business activities in the foreign country of incorporation.

Under a 60% inversion, 26 USC § 7874 will not apply.

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¹¹Source: *Id.* P.6 https://www.irs.gov/pub/int_practice_units/isocup_1_10_01.pdf.

¹² Source: https://www.irs.gov/pub/int_practice_units/isocup_1_10_01.pdf.



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