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LEGAL INFORMATIVE NEWSLETTER

No. 1 January 2016

We are pleased to provide you with the new issue of our legal information newsletter.

Topical legal questions are discussed and those related to issues that you might encounter.

We hope that you will find it of interest. We would welcome any comment you might have.

SUBSIDIARY VERSUS BRANCH – TAX, REGULATORY ASPECTS, MAJOR ADVANTAGES AND DISADVANTAGES WHEN SETTING UP IN ITALY

(I) INTRODUCTION - Business companies operating in Italy can set up a subsidiary (company) or a branch (permanent establishment). The treatment of these entities is rather different and the options require careful consideration. We highlight the main differences below.

A permanent establishment (branch) is generally defined as a fixed site through which the business of the company is wholly or partially carried out within that territory.

A subsidiary is a separate legal entity, so liabilities arising within the company cannot be claimed against another company in the group.

To set up a subsidiary in Italy the assistance of a public notary is necessary. To set up a branch in Italy it is equally necessary to file the relevant documents with a public notary.

From a fiscal perspective, an Italian branch is subject to as the same taxation as an Italian limited liability company or a corporation.

Differently from a subsidiary, a branch office is not a separate legal entity of the parent corporation. In case of a branch, the parent company is directly responsible for all the debts of the Italian branch, while in the case of a subsidiary, the company's creditors may satisfy their claims only against the assets of the

company. The liability of the Stockholders is limited to the amount of the participation subscribed by each of them.

The procedure for the setting up of a subsidiary is simpler than the one necessary for the setting up of a branch, and both from an administrative and fiscal perspective, are equally difficult to manage.

The Italian branch must file its parent company balance sheet with the Companies' Register and the balance sheet of the parent company must be translated into Italian.

The transfer of the profits from the Italian branch to the Parent company is not subject to any withholding tax. However, the payment of dividends from the Italian subsidiary to the Parent company may be subject to a withholding tax depending on the following circumstances.

(II) WITHHOLDING TAXES ON DIVIDENDS, INTERESTS AND ROYALTIES

(a) Withholding Taxes on Dividends - Dividends paid by resident companies to other resident companies are not subject to withholding tax. However, a final withholding tax of 26% might apply to dividends paid by a resident company to a non-resident company, e.g. if the non resident company is not located in another EU Member State.

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A partial refund may be claimed by a non-resident recipient who demonstrates, by means of proper documentation issued by the tax authority in his country of residence, that a final tax on the same dividends has been paid there.

The Italian authorities refund this final tax in the amount of up to 11/26 of the Italian withholding tax. As a result, the effective Italian withholding tax may be reduced up to 15%.

Tax treaties usually reduce the above percentage of the withholding tax.

The withholding tax on dividends is reduced to 1.375%, provided that the beneficial owner of the dividends is a company that is subject to corporate income tax in another European Union Member State, or in another State of the European Economic Area that allows an adequate exchange of information with the Italian tax authorities.

In addition, under the provisions that make the European Union (EU) Parent-Subsidiary Directive effective in Italy, **no withholding tax is levied on dividends paid to a parent company in another Member State if**:

- both the parent and the subsidiary are qualifying companies under the Directive, e.g. limited liability companies (S.r.l.) or corporations (S.p.a.);
- the parent is subject to corporate tax in a Member state without any exemption or limitation;
- the parent has held at least 10% of the capital of the subsidiary for a period of at least 1 year.

Documentation issued by the competent authority of the Member State is required, certifying that the European Union (EU) company meets the conditions necessary to benefit from the withholding tax exemption.

The parent-subsidiary regime is not available for dividends received by EU companies controlled by persons who are not residents of an EU Member State, unless such persons can prove that the participating interest is not held for the sole purpose of benefiting from the special regime for EU outbound dividends.

Under art. 15 of the agreement (Savings Agreement) of 26 October 2004 between the European Union and Switzerland providing for measures equivalent to those set forth in the EU Savings Directive, the EU Member States must exempt dividend payments to companies resident in Switzerland under essentially the same conditions as those set forth in the EU Parent-Subsidiary Directive, except that a minimum holding of 25% for at least 2 years is required.

(b) Withholding Taxes on Interest - Interest paid by resident companies to other resident companies is not subject to withholding tax.

No withholding tax is levied on interest paid to non-resident companies on deposit accounts and current accounts with banks and post offices.

Interest paid to non-residents on bonds issued by the state is exempt from withholding tax if the recipient is a resident of a country with which Italy has an adequate exchange-of-information system (a whitelist of the states and territories that have an adequate exchange-of-information system has been issued by a ministerial decree).

The same provision applies to interest on bonds issued by banks or quoted companies. In order to benefit from this exemption, the non-resident must deposit the bonds with a resident bank or other approved intermediary. The non-resident must submit a special statement to the resident bank or intermediary to certify the above requirements.

Interest on bonds other than the above is subject to a 26% withholding tax.
Other types of interest paid to non-resident companies, including interest on loans, are subject to a 26% withholding tax.

The withholding tax on payments to non-resident companies is always final. As said, the percentage of the withholding tax may be reduced by tax treaties.

Under the domestic law provisions implementing the European Union (EU) Interest and Royalties Directive (2003/49/EC), interest payments arising in Italy are exempt from any Italian tax imposed on those payments, whether by deduction at source or by assessment, provided that the beneficial owner of the interest is a company of another EU Member State or a permanent establishment situated in another EU Member State of a company of an EU Member State.

The exemption applies if the person making the payments and the beneficial owner of the payments are companies (or permanent establishments of companies) that fulfill the requirements set forth in Annexes A (legal form) and B (subject to tax) of the domestic law, which correspond to the requirements of the Directive.

A further condition requires that the company that makes the payment and the company that benefits from the payment must be "associated" as per the wording of the Directive. More specifically:

- the first company directly holds a participation equal to at least 25% of the voting rights in the second company, or
- the second company directly holds a participation equal to at least 25% of the voting rights in the first company, or
- a third company, fulfilling the requirements under Annexes A and B of the domestic law, directly holds a participation equal to at least 25% of the voting rights in both the first and the second companies.

The above-mentioned participations must be held for an uninterrupted period of at least 1 year.
The request for the application of the exemption regime must be substantiated by (1) an attestation by the tax authorities in the beneficial owner's residence state and (2) a declaration by the beneficial owner regarding the fulfilment of the legal form and subject-to-tax requirements.

As regards the definition of "interest", the domestic law follows the Directive. Accordingly, the term includes income from debt claims of all kinds, whether or not secured by mortgage, and, in particular, income from securities and income from bonds or debentures, including premiums attached to such securities, bonds or debentures.

The exemption does not apply where the amount of the interest exceeds the amount that would have been agreed upon by the payer and the beneficial owner in the absence of a special relationship between the two parties (i.e. "Fair Value"). Such a special relationship exists when one party directly or indirectly controls the other, or when both parties are directly or indirectly controlled by the same third party.

In addition, the exemption may be denied by virtue of the general anti-avoidance rule (see Taxation of Resident Companies - General Anti-Avoidance Rule).
Under art. 15 of the agreement (Savings Agreement) of 26 October 2004 between the European Union and Switzerland providing for measures equivalent to those set forth in the EU Savings Directive, the EU Member States must exempt interest payments to companies resident in Switzerland under essentially the same conditions as those set forth in the EU Interest and Royalties Directive (however, the participations must be held for an uninterrupted period of at least 2 years).

(c) Withholding Taxes on Royalties - In this context the term "royalties" means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work (including cinematograph films, and films or tapes for radio or television broadcast), any patent, trade mark, design or model, plan, secret formula or process. or for the use of, or the right to use, industrial, commercial or scientific equipment, or for information concerning industrial, commercial or scientific experience.

Royalties paid by resident companies to other resident companies are not subject to withholding tax.

Royalties paid by a resident company to a non-resident company without a permanent establishment in Italy are subject to a final 30% withholding tax. However, except for the royalties for the use of, or the right to use, industrial, commercial or scientific equipment, the tax is generally applied to 75% of the gross amount of the payment, resulting in an effective rate of 22.5%.

The tax treaties may reduce the percentage of the withholding tax. However, the rates under tax treaties apply to 100% of the gross royalties.

Under the domestic law provisions implementing the European Union (EU) Interest and Royalties Directive (2003/49/EC), royalty payments arising in Italy are exempt from any Italian tax imposed on those payments, whether by deduction at source or by assessment, provided that the beneficial owner of the royalties is a company of another EU Member State or a permanent establishment situated in another EU Member State of a company of an EU Member State.

The exemption applies if the person making the payments and the beneficial owner of the payments are companies (or permanent establishments of companies) that fulfil the requirements set forth in Annexes A (legal form) and B (subject to tax) of the domestic law, which correspond to the requirements of the Directive.

A further condition requires that the company that makes the payment and the company that benefits from the payment must be "associated" as per the wording of the Directive. In other words:

- the first company directly holds a participation equal to at least 25% of the voting rights in the second company, or
- the second company directly holds a participation equal to at least 25% of the voting rights in the first company, or
- a third company, fulfilling the requirements under Annexes A and B of the domestic law, directly holds a participation equal to at least 25% of the voting rights in both the first and the second companies.

The above-mentioned participations must be held for an uninterrupted period of at least 1 year.

The request for the application of the exemption regime must be substantiated by (1) an attestation by the tax authorities in the beneficial owner's residence state and (2) a declaration by the beneficial owner regarding the fulfilment of the legal form and subject-to-tax requirements.

The term "royalties" includes:

- payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work, including cinematograph films and software, any patent, trademark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience, and
- payments for the use of, or the right to use, industrial, commercial or scientific equipment.

The exemption does not apply where the amount of the royalties exceeds the amount that would have been agreed upon by the payer and the beneficial owner in the absence of a special relationship between the two parties (i.e. "Fair Value").

Such a special relationship exists when one party directly or indirectly controls the other, or when both parties are directly or indirectly controlled by the same third party.

In addition, the exemption may be denied by virtue of the general anti-avoidance rule (see Taxation of Resident Companies – General Anti-Avoidance Rule).

Under art. 15 of the agreement (Savings Agreement) of 26 October 2004 between the European Union and Switzerland providing for measures equivalent to those set forth in the EU Savings Directive, the EU Member States must exempt royalty payments to companies resident in Switzerland under essentially the same conditions as those set forth in the EU Interest and Royalties Directive (however, the participations must be held for an uninterrupted period of at least 2 years).

(d) Tax Treaties - The tax treaties may reduce the percentage of the domestic withholding tax.

If a tax treaty reduces the domestic withholding tax rate, the withholding agent may apply the lower treaty rate directly, but under its own responsibility. The reduced rate may only be applied if the recipient provides the agent with a residence certificate, validated by the tax authorities of its country of residence on the bases of information they have available, stating that the recipient:

- is a resident of the treaty partner state,
- is the beneficial owner of the payment, and
- does not have a permanent establishment in Italy to which the payment is attributable.

(III) SUMMARY OF THE MAJOR ADVANTAGES AND DISADVANTAGES OF A BRANCH

1. Advantages of a Branch

a. A branch does not require either directors or statutory auditors. It can be run by an executive to whom the necessary authority has been delegated. This greatly reduces the formalities which are otherwise necessary for the management of the company (i.e. General meetings, Board of Directors, etc.).

b. A branch is not required to have a minimum statutory capital.

c. A branch can incur any amount of losses on its books, offsetting the same against financing from its parent company or from bank loans, while under present Italian legislation a company (S.r.l. or S.p.A.) which records a loss greater than one-third of its issued capital must effect a capital reorganisation.

d. A branch is subject to the same income taxes of a subsidiary with the only difference that profits remitted by a branch are not subject to any withholding tax.

e. Procedure to close down a branch is very simple while in case of a corporation it is necessary to go through the liquidation procedure.

f. The losses of a branch are deductible from the profits of the parent company directly and immediately while this is generally not possible for subsidiaries.

g. The cost (taxes included) of setting up a branch is less relevant than the cost for a subsidiary.

2. Disadvantages of a Branch

a. The parent company's domestic operations may be subject to various degrees of surveillance by the Italian Tax Authorities who might request financial data and confidential information when considering the taxability of a local branch.

b. Due to the so-called "force of attraction rule", interests, dividends and gains derived from operations carried on in Italy by the parent company, have to be imputed to its Italian branch, (except when the Tax Treaty provisions expressly deviates from this rule).

c. In the event of bankruptcy, the shareholders (i.e. the parent company) of a subsidiary would not be responsible for liabilities exceeding the share capital (unless the company has a sole shareholder). On the other hand, if a branch put into bankruptcy, the parent company is responsible for all the branch's liabilities. This full liability occurs also as far as tax liabilities are concerned.

d. In the event that, due to the enlargement of the size of the business, it is decided to transform the branch into a subsidiary, the contribution of the former into the latter may be expensive because of the taxation of goodwill which may have been created over a certain period. This is because it is not technically possible to convert a branch office into a subsidiary.

In order to develop the business from branch to subsidiary, the branch office must be winded up and a new subsidiary, which will acquire the going concern of the former branch must be constituted.

e. Finally, there is more general consideration. There are very few provisions of the Italian law dealing with a branch, while a subsidiary is regulated in detail.

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