THE NEW U.S.-ITALY TREATY: A U.S. PERSPECTIVE

Abstract: El siguiente artículo discute las principales nuevas disposiciones y examina su compatibilidad con la política regular de tratados de los EEUU, tal como se estableció en el Modelo EEUU de 2006 y en los tratados sobre impuestos de los últimos años. En particular, el artículo se enfoca en las nuevas reglas de imposición en la fuente, el nivel impositivo de las branch, las reglas de atribución de beneficios, la aplicabilidad de los tratados a entidades transparentes y la limitación en los beneficios y otras disposiciones anti-abusivas. La atención se centra en el método para eliminar la doble imposición en el Irap.

SOMMARIO: I. Rules of Taxation – A. Passive Income – B. Branch Level Tax – C. Attribution of Business Profits – D. Pensions – II. Eligibility for Benefits – A. Fiscally Transparent Entities – B. Limitation on Benefits and Other Anti-Abuse Provisions – C. Main Purpose Clause – III. Mutual Cooperation – A. Exchange of Information – B. Dispute Resolution and Arbitration – IV. Elimination of Double Taxation – A. IRAP – B Resourcing Rules – V. Conclusion.

Introduction

On March 3, 2009, the Italian Parliament approved a new U.S.-Italy income tax treaty[1], which had been signed on August 25, 1999. The reasons for the ten-year delay between signature and approval are not clear. They may have stemmed from the United States' reservation with respect to certain anti-avoidance provisions and a Senate Understanding on exchange of information[2]. On the other hand, some observers have speculated that Italy hesitated to approve the treaty while the European Court of Justice appeared ready to invalidate the Italian Regional Tax on Productive Activities (l'*Imposta Regionale sulle Attività Produttive*, or "IRAP"). In the treaty, Italy had made significant concessions on source-country tax rates in exchange for a partial foreign tax credit for the IRAP, and invalidation of the

[1] Convention Between the Government of the United States of America and the Government of the Italian Republic for the Avoidance of Double Taxation with Respect to Taxes on Income and the Prevention of Fraud or Fiscal Evasion Done at Washington on August 25, 1999.

[2] Senate Floor Action and Debate, 145 Cong. Rec. 14225-7 (Nov. 5, 1999).

IRAP would have eliminated one side of this bargain[3]. In October 2006, the ECJ found that the IRAP was sufficiently distinct from a value added tax to escape invalidation[4]; yet the treaty remained pending for another two and a half years prior to the recent action by the Italian Parliament.

Whatever the reason for the delay, the new treaty makes significant changes in the U.S. tax relationship with Italy. These are most evident in the reduced rates at source and IRAP creditability provisions, but the treaty also includes expanded limitation on benefits rules, elimination of the prior exemption from branch tax, more elaborate rules for the taxation of pensions, and a new arbitration provision. The Technical Explanation indicates that the treaty reflects the U.S. Treasury Department's tax treaty policy as reflected in its Model Income Tax Convention of September 20, 1996 (the "1996 U.S. Model") and then recently negotiated U.S. treaties, as well as the Model Income Tax Convention on Income and on Capital published by the OECD in 1992 and amended in 1994, 1995, and 1997, and recent treaties concluded by Italy. U.S. treaty policy has evolved considerably over the decade since signature, however, and a new U.S. Model Treaty was published in 2006. The OECD Model has also undergone several revisions. As a result, the new Italian treaty lacks several provisions that have more recently become commonplace in U.S. treaties and in many respects the new treaty appears outdated.

The following article discusses the principal new provisions and examines their compatibility with current U.S. treaty policy as set forth in the 2006 U.S. Model and tax treaties over the past few years. The article also notes certain provisions that were not revised in the new treaty and compares them with provisions in the current U.S. Model and more recently negotiated U.S. treaties.

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[3] Lee A. Sheppard, "Where is the Italian Treaty?: Part 2," *Tax Notes Int'l*, Apr. 10, 2006, p. 93.

[4] Case C-475/03, *Banca Populare di Cremona Soc. Coop. al v. Agenzia Entrate Ufficio Cremona*, 2006 E.C.R. I-9373.

I. *Rules of Taxation*

A. *Passive Income*

The most extensive changes to the treaty appear in the provisions governing source taxation of passive income - dividends, interest, and royalties. The 1984 U.S-Italy treaty[5] that is replaced by the new treaty provides three rates for dividends: generally 15 percent, but 10 percent if the beneficial owner of the dividends is a corporation owning 10 percent or more of the voting stock of the company paying the dividends, and 5 percent if a corporate beneficial owner owns 50 percent or more of the voting stock. To qualify for the 10 percent or 5 percent rates, the owner must own the stock of the company paying the dividends for a 12-month period ending on the date the dividend is declared, and no more than 25 percent of the gross income of the company paying the dividends can be derived from interest and dividends (with exceptions for interest derived in a banking or financing business and interest and dividends received from subsidiaries).

The new treaty eliminates the 10 percent rate and lowers the threshold for the 5 percent rate to a beneficial ownership stake of 25 percent. The new treaty also eliminates the provision prohibiting companies with substantial passive income from qualifying for the 5 percent rate[6]. Finally, the new treaty provides an exemption from source-country tax for dividends paid to a governmental entity that holds less than 25 percent of the voting stock of the company paying dividends[7].

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[5] Convention Between the Government of the United States of America and the Government of the Republic of Italy for the Avoidance of Double Taxation with Respect to Taxes on Income and the Prevention of Fraud or Fiscal Evasion Done at Rome on April 17, 1984.

[6] The new treaty appears to have replaced this provision with a denial of the 5 percent rate to United States Regulated Investment Companies ("RICs") and United States Real Estate Investment Trusts ("REITs"). REITS are barred from qualifying for any reduction of tax under the treaty unless the beneficial owner's interest in the REIT falls below certain thresholds. Article 10(9) of the treaty. Similar provisions appear in Article 10(3) of the 1996 U.S. Model and Article 10(4) of the 2006 U.S. Model. According to the U.S. Department of Treasury Technical Explanation, the purpose of this provision is to prevent Italian taxpayers from transforming diversified portfolio investments and real estate income into direct investment dividends taxable only at 5 percent. Although the Technical Explanation to the 1984 treaty is silent on the subject, it is likely that its 25 percent passive income limitation served a similar purpose.

[7] Article 10(8) of the treaty. The Technical Explanation states that this exemption is analogous to the exemption already provided under U.S. domestic law by section 892 of the Internal Revenue Code and makes the exemption reciprocal.

The rate of taxation on interest is reduced in the new treaty from 15 percent to 10 percent, and new exemptions are established for interest paid or accrued with respect to sales on credit of goods, merchandise, or services provided by one enterprise to another enterprise, and for interest paid or accrued in connection with sales on credit of industrial, commercial, or scientific equipment[8]. A protocol provides an anti-abuse exception to these reductions of source-country taxation for interest that is an excess inclusion with respect to a real estate mortgage investment conduit ("REMIC")[9].

The new treaty also reduces the rate on royalties. The 1984 treaty provides three different rates: 5 percent for the use of any copyright of literary, artistic or scientific work, 8 percent for the use of motion pictures, tapes, or other means of reproduction used for radio or television broadcasting, and 10 percent for all other types of royalties[10]. The new treaty eliminates the tax for the use of any literary, artistic, or scientific copyright and reduces the rate to 5 percent for the use of computer software or industrial, commercial, or scientific equipment, and to 8 percent for all other royalty payments[11].

Despite these reductions, the tax rates in the new treaty are high compared to those negotiated by the United States in treaties with other developed nations. Both the 1996 and 2006 U.S. Models require only 10 percent beneficial ownership of a company paying dividends to qualify for the 5 percent rate on dividends, and the Models would completely eliminate taxation of interest and royalties at source. The United States has been able to obtain lower rates in recent negotiations with many developed country treaty partners, including Canada, the United Kingdom, Belgium, and France.

B. *Branch Level Tax*

The new treaty allows the United States to impose its branch profits tax and branch-level interest tax on U.S. branches of Italian corporations. Both taxes were enacted subsequent to negotiation of the 1984 treaty[12].

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[8] Article 11(2)-(4) of the treaty.

[9] Article 1(11) of the protocol. This exception is consistent with the policy of sections 860E(e) and 860G(b) of the Internal Revenue Code that excess inclusions with respect to REMICs should bear full U.S. tax in all cases.

[10] Article 12(2) of the 1984 U.S. Italy treaty.

[11] Article 12(2) of the treaty.

[12] The branch tax regime appears in section 884 of the Internal Revenue Code, enacted in 1986.

Thus, the new treaty permits each country to tax a foreign corporation on a "dividend equivalent amount" (or, in the case of Italy, an analogous amount) if the corporation has income attributable to a permanent establishment in the country, derives income from real property in the country which is taxed on a net basis under Article 6, or realizes gains in the country taxable under paragraph 1 of Article 13[13]. From a U.S. perspective, the purpose of this provision is to allow the United States to impose its branch profits tax on an amount approximating the dividend the branch would have paid if it had operated as a subsidiary rather than a branch[14] The tax is imposed on after-tax business profits of an Italian corporation attributable to a permanent establishment in the United States, income from U.S. real property which the corporation elects to have taxed on a net basis under section 882(d) of the Internal Revenue Code, and gain from the disposition of a "United States Real Property Interest" other than an interest in a "United States Real Property Holding Corporation"[15].

The new treaty also contains a provision specifically permitting the U.S. branch-level tax on excess interest[16]. Under domestic law, if the interest deduction allowed to a foreign corporation exceeds the interest paid by the corporation's U.S. branch, the corporation is subject to tax on the excess as

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[13] Article 10(6) of the treaty. Imposition of the branch profits tax was prohibited under Article 10(5) of the 1984 treaty, which provided that a contracting state might not subject the undistributed profits of a company resident in the other state to a tax on undistributed profits, even if the undistributed profits consisted of profits or income arising in that contracting state. A substantially identical provision appears in the new treaty but is subject to the exception contained in Article 10(6).

[14] The Technical Explanation clarifies that the term "dividend equivalent amount" has the same meaning as for purposes of section 884 of the Internal Revenue Code. Under that section, the dividend equivalent amount is generally measured as after-tax branch earnings less the portion of those earnings that is reinvested in branch operations. I.R.C. § 884(b).

[15] Technical Explanation, article 10(6). Generally, U.S. domestic law does not tax foreign persons on gains on sales and exchanges of property that are not effectively connected with business done in the United States. Section 897 of the Internal Revenue Code provides an exception to this rule and taxes foreign persons on dispositions of United States Real Property Interests, defined as interests in real property located in the United States or the U.S. Virgin Islands. Such amounts are factored into the calculation of the dividend equivalent amount. Gains from the disposition of an interest in a United States Real Property Holding Corporation, defined as a domestic corporation holding U.S. Real Property Interests exceeding 50 percent of the fair market value of the corporation's total real property and business assets, do not factor into the calculation of the dividend equivalent amount. See I.R.C. § 884(d)(2).

[16] Article 11(8) of the treaty.

though that excess were interest received from a domestic subsidiary[17]. In 1989, the Internal Revenue Service issued a notice stating that this provision was not prohibited by any U.S. treaty then in force, including the 1984 treaty with Italy.[18] Nevertheless, subsequently negotiated treaties have tended to include provisions explicitly allowing the tax[19].

C. *Attribution of Business Profits*

As in the 1984 U.S.-Italy treaty, Article 7 (Business Profits) of the new treaty adheres closely to the Business Profits provisions of the OECD Model[20]. The article thus fails to reflect a current trend in U.S. treaty policy to make explicit the U.S. reliance on the OECD Transfer Pricing Guidelines in attributing profits to permanent establishments. The 2006 U.S. Model added language to paragraph 2 of Article 7 to clarify that, "the profits attributed to the permanent establishment shall include only the profits derived from the assets used, risks assumed and activities performed by the permanent establishment." A footnote to paragraph 3 of Article 7 of the 2006 U.S. Model states that a protocol or notes to a treaty should provide that the principles of the OECD Transfer Pricing Guidelines apply for purposes of determining the profits attributable to a permanent establishment and, in particular, notes that "the permanent establishment shall be treated as having the same amount of capital that it would need to support its activities if it were a distinct and separate enterprise engaged in the same or similar activities"[21].

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[17] I.R.C. § 884(f)(1)(B).

[18] Notice 89-80, 1989-2 C.B. 394.

[19] For example, the 2008 protocol to the U.S.-New Zealand treaty contains such a provision.

[20] One provision that differs from the OECD Model is new paragraph 6, which provides that any income or gain attributable to a permanent establishment or fixed base during its existence is taxable in the country where the permanent establishment or fixed base was located, even if payments are deferred until after the permanent establishment or fixed base ceased to exist. This provision reflects the rule of section 864(c)(6) of the Internal Revenue Code, enacted in 1986, which prevents foreign taxpayers from avoiding U.S. tax on income effectively connected with a U.S. trade or business by deferring it to a year in which the taxpayer no longer engages in a U.S. trade or business

[21] The Technical Explanation to the 2006 U.S. Model states that U.S. domestic law principles, embodied in section 1.882-5 of the Treasury Regulations, do not take the riskiness of assets into account when attributing capital to a permanent establishment. Since accounting for such risk may present an administrative burden for taxpayers, the

D. *Pensions*

The new treaty makes substantial changes to Article 18 (Pensions, Etc.), addressing the taxation of social security benefits, the taxation of lump-sum payments or severance payments, and the treatment of cross-border pension contributions[22]. Contrary to both versions of the U.S. Model, the new treaty provides that payments under social security or similar legislation are taxable only in the state of the recipient's residence[23]. The treaty also adds a provision to the effect that lump-sum payments or severance payments received after a change of residence with respect to employment exercised in the country of prior residence will be taxed solely in that country[24].

The most significant changes to Article 18 appear in paragraph 6, which allows a deduction for both employees and employers for cross-border contributions to pension plans. It also exempts from income tax both pension benefits accrued and employer contributions made during a period of employment in the country where the taxpayer does not reside[25].

Model would allow a choice between the treaty's methodology for allocating capital and that set forth in section 1.882-5 of the Treasury Regulations.

[22] Article 18(2), (3), and (6) of the treaty.

[23] Article 18(2) of the treaty. Although the 1984 treaty did not explicitly address social security payments, this new provision does not represent a substantive change. The payments would have been captured under the general rule in paragraph 1 of Article 18 that pension payments are taxable only the country of the recipient's residence.

[24] The Treasury Technical Explanation states that this provision is intended to prevent a resident of one country from establishing residence in the other country to obtain more favorable taxation of a lump-sum payment. The U.S. treaty with the Netherlands contains a similar provision granting non-exclusive taxation rights to the source country when a change of residence occurs at any time during the five-year period preceding payment. The Technical Explanation to that treaty explains that it is the preferred policy of the United States not to distinguish the treatment of lump sum and periodic pension payments, but that the provision had been added to accommodate the Netherlands' policy to preserve the right of the Netherlands to tax any lump-sum pension payment made in consideration of employment in the Netherlands. It is likely that the provision in the Italian treaty was included in consideration of a similar Italian policy.

[25] Paragraph 6 provides that contributions to pension plans established and recognized under the laws of one country shall be deducted or excluded in the other country when the contributions are paid by or on behalf of the participant during a period of time when the participant is performing personal services in the other country. In addition, benefits accrued under such a plan or payments made to such a plan by or on behalf of the participant's employer during that period shall not be treated as part of the participant's taxable income and will be allowed as a deduction in computing the employer's profits in the other country. However, paragraph 6(b) states that the provision will apply only if contributions were made by or on behalf of the participant before he arrived in the other country. The competent authority of the other country must also

The provisions governing contributions to pension funds are largely modeled on the 1996 U.S. Model[26] and do not reflect the significantly expanded pension provisions in the 2006 U.S. Model and several more recently negotiated U.S. treaties[27]. The Technical Explanations to both the new treaty and the 1996 U.S. Model state that the provisions governing pension contributions are intended to apply only when a resident of one country performs dependent or independent personal services in the other country as a visitor[28]. In contrast, the 2006 U.S. Model situated provisions dealing with pension funds in an entirely new Article 18 addressing an array of issues[29]. That article provides that when a resident of one country participates in a plan established under the laws of the other country, income earned by the plan may be taxed to the participant only when paid. The article also addresses contributions to a pension fund in one country in respect of employment in the other country, regardless of the participant's country of residence. The Model provides that such contributions, whether made by the participant or the employer, are deductible, and any benefits that accrue under the plan are not to be treated as taxable income to the participant[30]. Finally, the 2006 U.S. Model includes provisions requiring that the U.S. tax treatment of contributions by U.S. citizens resident in the other country to pension funds in that country will be comparable to the treatment of contributions to U.S. funds[31].

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agree that the pension plan generally corresponds to a pension plan recognized for tax purpose by that country. The benefits granted by the provision are limited to the benefits that would be allowed by the other country to its residents for contributions to or benefits accrued under a pension plan recognized for tax purposes by that country.

[26] The provisions of the treaty seem to be drawn almost verbatim from the 1996 U.S. Model, but the new treaty omits certain provisions of the 1996 U.S. Model that exempt plan participants from tax on undistributed earnings realized by the plan and from tax on rollovers from one plan to another. Article 18, subparagraphs 6(b) and (c), of the 1996 U.S. Model. The Technical Explanation to the new treaty does not indicate why these provisions were omitted.

[27] The 2001 U.S.-U.K. treaty and the 2006 protocol to the U.S.-Germany treaty contain provisions substantially similar to Article 18 of the 2006 U.S. Model.

[28] Technical Explanation, article 18.

[29] Article 18 of the 2006 U.S. Model. Article 17 now contains the provisions dealing with recipients of pensions, social security, annuities, alimony, and child support.

[30] Article 18(2) of the 2006 U.S. Model. Article 18(3) limits the benefits in paragraph 2 in the same manner as paragraph 6(b) of the new U.S.-Italy treaty. *See supra* note 26.

[31] Article 18(4) of the 2006 U.S. Model.

II. *Eligibility for Benefits*

A. *Fiscally Transparent Entities*

One glaring omission from the new treaty is a modern and sophisticated provision dealing with income derived through hybrid and reverse hybrid entities[32]. Prior to 1995, the IRS determined the classification of foreign entities as corporations or partnerships by testing for the presence or absence of certain corporate characteristics. In 1995, however, it announced that it was abandoning this practice in favor of a system that would allow many entities, including foreign entities, to elect treatment as either non-transparent associations (corporations) or fiscally transparent entities for U.S. tax purposes[33]. By the end of 1996, the Treasury Department had promulgated final regulations instituting this so-called "check-the-box" regime, effective January 1, 1997[34]. The result was a proliferation of hybrid and reverse hybrid entities.

Perhaps anticipating this development, the 1996 U.S. Model revised the definition of "resident" with respect to fiscally transparent entities. Instead of classifying these entities as resident or non-resident in either country the Model provision examines individual items of income earned through the entities[35]. When an item of income is derived through an entity that is fiscally transparent under the laws of either country, it is considered to be derived by a resident of a country to the extent the country treats the income as income of a resident for purposes of its tax law. Thus, the treatment of an entity as fiscally transparent or nontransparent in the country of asserted residence will govern the determination of who derives income, and income is not eligible for a reduction of source-state taxation unless the other country considers it income of a resident.

Curiously, the provision governing the treatment of fiscally transparent entities in the new U.S.-Italy treaty is based on the 1981 U.S. Model, even

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[32] The terms "hybrid" and "reverse hybrid" entities are employed from a U.S. perspective. A hybrid entity is an entity that is fiscally transparent in the United States and non-transparent in the foreign jurisdiction. A reverse hybrid entity is an entity that is non-transparent in the United States and fiscally transparent in the foreign jurisdiction.

[33] Notice 95-14, 1995-1 C.B. 297. Furthermore, transparent entities with a single owner were to be disregarded as entities and their assets were viewed as directly owned by the single owner.

[34] T.D. 8767, 1998-1 C.B. 875. The regulations are contained in section 301.7701-3 of the Treasury Regulations.

[35] Article 4(1)(d) of the 1996 U.S. Model. The 2006 U.S. Model contains an identical provision in Article 1.

though the United States referred to the 1996 Model in its negotiations. The provision does not deal with the "derivation" of income but relies instead on the definition of "resident," stating that residents include partnerships, estates, and trusts only to the extent that income derived by such entities is taxable in the country of claimed residence, either in the hands of the partnership, estate, or trust or in those of its partners or beneficiaries[36].

Although the results under the treaty are somewhat unclear, the provision might permit the use of hybrid and reverse hybrid entities to reduce source country taxation on items of income that are not taxed by the residence country. For example, when dividends, interest, or royalties are derived through an entity that the source country views as transparent but the residence country treats as non-transparent, the beneficial owners of the income are the partners or beneficiaries of the entity[37]. If the partners or beneficiaries are residents of the treaty partner, income derived through the entity appears to qualify for treaty benefits. It is not clear that the residence of the entity itself is relevant. Since the residence country views the entity as fiscally non-transparent, its income would not be subject to tax in the residence country if it is formed in the source country or a third country.

Conventions that treat fiscally transparent entities as residents have been heavily criticized by the OECD[38]. Perhaps recognizing the drawbacks of such a provision, the Treasury Department stated in its Technical Explanation that results under the new treaty with Italy are intended to be the same as under the 1996 U.S. Model. U.S. courts have tended to assign little weight to such technical explanations, however, and the Treasury Department's interpretation would ignore the literal text[39]. Thus, the treatment of income derived through hybrid and reverse hybrid entities under the new treaty is murky.

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[36] Article 4(1)(b) of the new treaty. Article 1(5)(d) of the protocol explains that that this provision is meant to determine the residence of any entity that is fiscally transparent under the laws of either country.

[37] Article 10(2) of the Technical Explanation states that the beneficial owner of the dividend for purposes of Article 10 is the person to which the dividend income is attributable for tax purposes under the laws of the source country. Similar explanations are provided for the other articles governing source taxation of passive income.

[38] The Application of the OECD Model Tax Convention to Partnerships, paragraphs 43-46 (adopted by the OECD Committee on Fiscal Affairs on January 20, 1999). One problem noted by the OECD is that when source state relief takes the form of a reduction in tax, it is not clear how the reduction should be calculated when some partners are treaty residents and others are not.

[39] *See e.g.*, *National Westminster Bank v. United States*, 58 Fed. Cl. 491, 499 (2003) ("[t]he unilateral views of the U.S. are not controlling… the court must give meaning to the intent of the treaty partners, not just the views of the U.S.")

B. *Limitation on Benefits and Other Anti-Abuse Provisions*

Article 2 of the protocol to the new treaty incorporates the greatly expanded limitation on benefits rules of the 1996 U.S. Model. The 1984 U.S.-Italy treaty denies the benefits of certain articles to entities unless more than 50 percent of the beneficial ownership of the entity is by individuals who are residents of either country, citizens of the United States, the countries themselves, or publicly traded companies. However, the provision only applies when the competent authority of the source country determines that the establishment, acquisition, maintenance, or operations of an entity had obtaining treaty benefits as its principal purpose[40].

The new limitation on benefits provision covers benefits under all articles of the treaty and applies automatically without any determination by the competent authorities. The provision allows the full benefits of the treaty to individuals, qualified governmental entities,[41] charities, and pension plans at least 50 percent of whose beneficiaries, members, or participants are individuals resident in either country[42]. Companies that satisfy a "publicly traded" test can qualify for benefits, as can any resident not otherwise eligible for benefits that satisfies an "ownership/base erosion" test or an "active trade or business" test[43]. The competent authority of the source country may also grant benefits to persons not otherwise entitled to them[44].

The publicly traded test allows treaty benefits to a company if all shares in the class or classes of shares representing more than 50 percent of the voting power and value of the company are regularly traded on a recognized stock exchange[45]. The company will also qualify if it is owned directly or indirectly by five or fewer companies meeting the publicly traded test, as long as each intermediate owner is entitled to benefits[46].

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[40] Article 2 of the protocol to the 1984 U.S.-Italy treaty.

[41] Qualified governmental entities are defined in Article 3(1)(i) of the treaty and Article 1(4) of the protocol.

[42] Article 2(2)(a), (b), (d), and (e) of the protocol.

[43] Article 2(2)(c), (f), and (3) of the protocol.

[44] Article 2(4) of the protocol.

[45] Article 2(2)(c) of the protocol. The Technical Explanation provides that the term "regularly traded" will be defined by reference to the domestic tax law of the source country. In the case of the United States, it will have the same meaning as under section 1.884-5(d)(4)(i)(B) of the Treasury Regulations. Under those regulations, a class of shares is considered "regularly traded" if trades in the class are made in more than de minimis quantities on at least 60 days during the taxable year, and the aggregate number of shares in the class traded during the year is at least 10 percent of the average number of shares outstanding during the year.

[46] Article 2(2)(c) of the protocol.

The “ownership/base erosion” test consists of two prongs. Under the first, persons qualifying for benefits as individuals, qualified governmental entities, charities, pension plans, or publicly traded companies must own, directly or indirectly, at lest 50 percent of each class of shares or other beneficial interest in the entity on at least half the days in the taxable year. In the case of indirect ownership, each indirect owner must be entitled to treaty benefits under any of the aforementioned tests or under the ownership/base erosion test. Under the second prong, the percentage of the entity’s gross income for the taxable year that can be paid or accrued, directly or indirectly, to persons who are not residents of either country in the form of payments that are deductible for income tax purposes in the entity’s country of residence must be less than 50 percent of gross income, unless the payments are to permanent establishments in either country.

The “active trade or business” test is available to entities not otherwise qualifying for treaty benefits with respect to certain items of income. The entity must be engaged in the active conduct of a trade or business in its country of residence, the income in question and with respect to which treaty benefits are claimed must be connected with or incidental to such trade or business, and the trade or business must be substantial in relation to the activity generating the income in the source country[47]. For purposes of determining whether a trade or business in the residence country is substantial, the treaty provides a safe harbor test based on a comparison of asset values, gross income, and payroll expense in each of the countries[48].

The 2006 U.S. Model limitation on benefits provision retains substantially the same structure as the provision included in the new U.S.-Italy treaty, including the publicly traded, ownership/base erosion, and active trade or business tests, but the tests have been refined somewhat. The publicly traded test in the 2006 Model extends the requirement that shares be regularly traded to any “disproportionate class of shares”, and adds a requirement that the principal class of shares be traded on a recognized stock exchange in the residence country or that the primary place of management

[47] Article 2(3) of the protocol. Article 2(3)(b) excludes the business of making or managing investments from the definition of “active trade or business” unless the activity is banking, insurance, or securities activity conducted by a bank, insurance company, or registered securities dealer. Article 2(3)(d) provides that income is derived in connection with a trade or business if the activity in the other country generating the income is a line of business that forms a part of or is complementary to the trade or business, and income is incidental to a trade or business if it facilitates the conduct of the trade or business in the country of residence.

[48] Article 2(3)(c) of the protocol.

and control be in that country[49]. The ownership/base erosion test in the 2006 Model requires, for the ownership prong, that shares or other beneficial interests represent at least 50 percent of the aggregate voting power and value of the entity and at least 50 percent of any disproportionate class of shares. It is also clarified that the second prong of the test extends not only to tax deductible payments to non-residents but also to payments to residents who do not qualify for benefits under the limitation on benefits rules. The exception for payments attributable to permanent establishments in either country is eliminated, but there is a new exception for arm's-length payments in the ordinary course of business for services or tangible property. For purposes of both the publicly traded and the base erosion test, intermediate owners need only be residents of either country rather than persons entitled to benefits under the limitation on benefits provisions. Finally, with respect to the "active trade or business test", the 2006 U.S. Model eliminates the safe harbor in the 1996 Model for determining whether a trade or business conducted in the residence country is substantial in relation to a trade or business conducted in the source country. However, the new Model allows activities of controlled or controlling entities to be aggregated with activities of the entity claiming treaty benefits.

C. *Main Purpose Clause*

Articles 10 (Dividends), 11 (Interest), 12 (Royalties), and 22 (Other Income) of the new treaty each originally contained a "main purpose clause" granting discretion to the tax authorities to deny treaty benefits in certain abusive cases that would not be covered by the limitation on benefits provision[50]. Each main purpose clause provided that benefits would be denied when the main purpose, or one of the main purposes, for the creation or assignment of shares or other rights in respect of which dividends, interest, royalties, or other income were paid was to take advantage of the pertinent article. The Technical Explanation states that, from a U.S. perspective, the purpose of these provisions was to clarify that U.S. domestic

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[49] Article 22(5) of the 2006 U.S. Model defines the term "disproportionate class of shares" as any class of shares that entitles the shareholder to a disproportionately higher participation, through dividends, redemption payments, or otherwise, in the earnings generated in the other country by particular assets or activities of the entity. "Principal class of shares" means the ordinary or common shares, provided that such class of shares represents the majority of the voting power and value of the entity, or the aggregate of the class of shares that represent the majority of the voting power in the entity.

[50] See Article 10(10), Article 11(9), Article 12(8), and Article 22(3) of the treaty.

law anti-abuse rules could be applied to deny treaty benefits to the types of abusive transactions covered by the articles. The Technical Explanation points out, however, that the absence of such a provision in other treaties would not foreclose the use of such doctrines to deny treaty benefits[51].

Although the Treasury expected that the main purpose test would eventually be incorporated into the U.S. Model, the Senate Foreign Relations Committee rejected the test in the U.S.-Italy treaty as too subjective and vague. Fearing that the provision would create difficulties for legitimate business transactions and hinder taxpayers' ability to rely on the treaty, the Senate adopted a reservation striking the test from the treaty[52].

The Technical Explanation notes that similar provisions had gained international currency because other countries may not have as many domestic law tools to prevent abuse. This appears to have been the case with Italy; the Technical Explanation notes that the main purpose test is actually narrower than anti-abuse provisions contained in certain of Italy's other treaties.

Other treaty partners have had greater success persuading the United States to include anti-abuse provisions apart from the limitation on benefits provision by narrowing the main purpose test somewhat. For example, the 2001 U.S. treaty with the United Kingdom denies treaty benefits for certain insurance premiums, dividends, interest, royalties, and other income paid in respect of a "conduit arrangement"[53]. To be classified as a conduit arrangement, a transaction must meet "main purpose" criteria similar to those originally found in the U.S-Italy treaty. In addition, the transaction in question must have been structured in such a way that a resident of one of the countries receives an item of income that would qualify for treaty benefits but pays all or substantially all of that income to another person who is neither a resident of the country of residence nor would be entitled to equivalent treaty benefits if it had received the income directly[54]. The United States believed that its domestic anti-abuse laws made the provision unnecessary but agreed to include it as an accommodation to the United Kingdom (likely because the United Kingdom agreed to accept zero percent tax at source on interest, royalties, and certain dividends)[55]. The Senate was

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[51] Technical Explanation, article 10(10).

[52] Senate Foreign Relations Committee Report (S. Exec. Rpt. 106-8), Nov. 3, 1999, at p. 5 [hereinafter, the "Senate Foreign Relations Committee Report"].

[53] See Articles 7(5), 10(9), 11(7), 12(5), and 22(4) of the U.S.-U.K. treaty.

[54] Article 3(1)(n) of the U.S.-U.K treaty.

[55] An exchange of letters between the United States and the United Kingdom confirmed the U.S. intention to interpret the provision in accordance with United States domestic law as it evolved over time, and that inclusion of the anti-conduit provisions in

satisfied that the second prong of the test limited the scope of the provision to situations involving objectively defined conduit payments, and therefore the provision was less vague and more narrowly defined than the "main purpose" test rejected in the U.S.-Italy treaty[56].

III. *Mutual Cooperation*

A. *Exchange of Information*

The new treaty contains provisions similar to the Exchange of Information provisions of the 1996 U.S. Model[57]. The provisions, however, omit the "bank secrecy" rule of Article 26(3) of the Model. That rule provides that, notwithstanding the provisions of Article 26 allowing a country to decline to carry out administrative measures that are at variance with its laws or administrative practice when fulfilling its exchange of information obligations[58], the country has authority to obtain and provide information held by financial institutions, nominees, or persons acting in a

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the treaty represented neither an expansion nor a contraction of U.S. domestic anti-abuse principles. *See* Letter from Barbara M. Angus, International Tax Counsel, Department of the Treasury, to Gabriel Makhlouf, Director, Inland Revenue, International Division, July 19, 2002.

[56] Joint Committee on Taxation, Explanation of Proposed Income Tax Treaty Between the United States and the United Kingdom (JCS-4-03), Mar. 3., 2003, at p. 77.

[57] Article 26(1) and (2) of the new treaty largely correspond to Article 26(1) and (2) of the 1996 U.S. Model. Although the Model provides that the competent authorities shall exchange such information as is "relevant" for carrying out the provisions of the treaty and the domestic tax laws of the contracting states, the new treaty provides for the exchange of such information as is "necessary." The Technical Explanation notes that the term "necessary" is drawn from the OECD Model and has been consistently interpreted as being equivalent to "relevant." Thus, the term is not to be interpreted as creating a higher threshold than "relevant."

Article 1(20) of the protocol includes a provision similar to that provided in Article 26(5) of the 1996 U.S. Model to the effect that the exchange of information provisions apply to taxes every kind imposed by the contracting states, not just the taxes to which the treaty applies generally.

Article 6 of the protocol is similar to Article 26(4) of the 1996 U.S. Model. However, the protocol provides that each country *may* collect on behalf of the other country such amounts as may be necessary to ensure that relief granted by the convention from taxation imposed by the other country does not enure to the benefit of persons not entitled to it. The Model states that such amounts *shall* be collected.

[58] Such provisions are contained in Article 26(2) of the treaty and Article 26(2) the 1996 U.S. Model.

fiduciary capacity. This information must be provided to the requesting country despite laws or practices of the requested country that would otherwise preclude obtaining such information, and regardless of whether the requested country needs the information for its own tax purposes[59].

The Treasury Department concluded that omission of that provision from the new treaty was insignificant, because Italian law permits exchange of the types of information envisioned by the Model provision, and the United States received assurances from the Italian Ministry of Finance regarding Italy's ability to exchange third-party information obtained from banks and other financial institutions[60]. Despite these assurances, the Senate Foreign Relations Committee was reluctant to approve the treaty without the bank secrecy language, fearing it would signal to other treaty partners that the U.S. commitment to greater transparency was weakening[61]. Thus, the Senate ratified the treaty subject to an Understanding that the competent authorities have the authority to obtain and provide information held by financial institutions, nominees, or persons acting in an agency or fiduciary capacity, or respecting interests in a person.

B. *Dispute Resolution and Arbitration*

The new treaty revises the Mutual Agreement Procedure to add a provision for arbitration[62]. Paragraph 5 of Article 25 provides that when the competent authorities have been unable to resolve a disagreement regarding application or interpretation of the treaty, the disagreement may be submitted, by mutual consent of the competent authorities and the affected taxpayers, for binding arbitration. Arbitration procedures will not come into effect until the countries have finalized such procedures through diplomatic notes. The protocol to the treaty provides that the countries will consult with each other within three years of the treaty's entry into force to determine whether an exchange of diplomatic notes to implement arbitration procedures is appropriate[63]. The parties also entered into a Memorandum of Understanding that broadly sketches the procedures to be used in arbitration

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[59] Article 26(3) of the 1996 U.S. Model.
[60] Technical Explanation, Article 26.
[61] Senate Foreign Relations Committee Report at p. 16.
[62] Article 25(5) of the treaty.
[63] Article 3(2) of the protocol.

but leaves many procedures to be determined by the competent authorities and the arbitration board itself[64].

The arbitration provision was included in the treaty at Italy's behest. At the time of negotiation, the Treasury Department generally did not favor arbitration in U.S. treaties and would agree to an arbitration provision only if it would be implemented upon a subsequent exchange of diplomatic notes. This would allow the United States time to evaluate the experience gained with similar provisions in other treaties and its general experience with the treaty partner before making a final determination[65].

Within a few years of the treaty's signing, however, the United States reversed its position on arbitration and became increasingly receptive to the idea of making arbitration compulsory for the resolution of mutual agreement disputes[66]. As a result, recent negotiations with several trading partners have resulted in arbitration provisions far more robust than the provision in the new treaty with Italy. The U.S.-Germany treaty, which the United States viewed as a test case for the new U.S.-Italy treaty[67], was substantially revised by a 2006 protocol to require mandatory arbitration. Recent U.S. negotiations with Belgium, Canada, and France have also resulted in mandatory arbitration provisions. The procedure adopted by all four of these treaties is "baseball arbitration," in which each country submits a proposed disposition of the specific amounts of income, expense, or tax in dispute, and a three-member arbitration panel chooses one of the proposals. The countries prepare position papers supporting their proposals and may, if

[64] Memorandum of Understanding, dated August 25, 1999, to the 1999 U.S.-Italy income tax treaty. The Memorandum states that if the competent authorities fail to reach an agreement within two years of the date on which a case was submitted to one of the competent authorities, they may agree to invoke arbitration, but only after fully exhausting the mutual agreement procedures laid out in Article 25 of the treaty. The Memorandum sets out general rules for choosing members of the arbitration board and provides that the board must decide each case on the basis of the treaty, giving due consideration to the domestic laws of the countries and the principles of international law, and must give an explanation of its decision.

[65] Senate Foreign Relations Committee Report at p. 14.

[66] At a 2001 American Bar Association Section on Taxation meeting, the Internal Revenue Service Director, International (the United States competent authority) announced that the United States competent authority no longer opposed the use of arbitration provisions and was in favor of compulsory arbitration. *See* 12 BNA Daily Tax Rpt. G-4 (Jan. 18, 2001).

[67] The Memorandum of Understanding specifically provided that the exchange of diplomatic notes would only occur if the experience with similar provisions in the European Community Convention on the elimination of double taxation and the U.S.-Germany income tax treaty proved to be satisfactory to the competent authorities of both countries.

they desire, prepare reply submissions. Additional information may be submitted to the arbitration panel only at its request. The panel applies the provisions of the treaty, any agreed commentaries or explanations of the treaty, the laws of the countries to the extent they are not inconsistent with each other, and any OECD materials regarding relevant portions of the OECD Model. The resolution of arbitration proceedings is binding on the countries, the panel does not produce a rationale or explanation, and its decision has no precedential value.

Such a provision is designed not only as a mechanism to resolve disputes but also as an incentive for competent authorities to reach prompt and reasonable settlements on their own, without arbitration. In its explanation of the arbitration provision in the Fifth Protocol to the U.S.-Canada treaty, the Joint Committee on Taxation noted that the average processing time for U.S. competent authority cases frequently approaches or exceeds two years, and some are never resolved. Believing that competent authorities would prefer to negotiate their own settlements rather than having an outcome imposed by an arbitration board[68], the Joint Committee speculated that mandatory arbitration provisions would impel the countries to reach agreement without arbitration[69].

The arbitration provision in the new treaty requires the consent of the taxpayer and both competent authorities, so its effectiveness is doubtful. However, given Italy's eagerness to include an arbitration provision in the treaty and the recent U.S. willingness to include more automatic mandatory arbitration provisions in its treaties, it seems possible and even likely that the countries will be receptive to revision of the new treaty to require compulsory arbitration.

IV. *Elimination of Double Taxation*

A. *IRAP*

The new treaty provides a partial foreign tax credit for IRAP, the Italian regional production tax. Effective January 1, 1998, IRAP replaced a previously existing local income tax, l'Imposta Locale sui Redditi ("ILOR").

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[68] This belief seems to have some support. The U.S. competent authority cited its concern that it would be handing off its job to an outside decision maker as the reason for its initial opposition to the inclusion of arbitration provisions in treaties. *See* 12 BNA Daily Tax Rpt. G-4 (Jan. 18, 2001).

[69] Joint Committee on Taxation, Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and Canada (JCX-57-08), Jul. 8, 2008, p. 105.

Unlike ILOR, which was a tax on net income, IRAP does not allow a deduction for labor costs or, for certain taxpayers, interest expense.

Article 2(2)(b)(iii) of the 1984 U.S.-Italy treaty specifically lists ILOR among the taxes to which the treaty applies, and article 23(2) allows a credit for ILOR. Article 2(3) also provides that any identical or substantially similar tax imposed after the date of signature of the treaty in addition to, or in place of, an existing tax will itself be a covered tax. Although no U.S. administrative or judicial rulings have ever addressed the creditability of IRAP under U.S. domestic law, the Internal Revenue Service has taken the position that IRAP is not sufficiently similar to ILOR to qualify for coverage under Article 2(3) of the 1984 treaty, and that it does not qualify as an income tax or tax "in lieu" of income tax eligible for a foreign tax credit under U.S. domestic law[70].

To provide relief for taxpayers during negotiation of the new treaty, the competent authorities of the United States and Italy reached a mutual agreement that IRAP would be considered a tax to which the existing treaty applies, subject to adjustments to its computation[71]. An identical provision has been incorporated in the new treaty[72]. Under the required calculation, the IRAP tax paid or accrued is reduced by the ratio of labor and interest expense not allowed as deductions to the total IRAP tax base. This calculation is intended to yield the approximate portion of the IRAP tax that falls on the net income of the taxpayer, as U.S. domestic law only allows a foreign tax credit for income taxes that reach net income[73].

Providing a partial credit for IRAP represents a departure from normal U.S. treaty policy. The Joint Committee on Taxation and the Senate Foreign Relations Committee both observed that that it is not generally consistent

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[70] Mutual Agreement Between United States and Italy on Partial Creditability of Italian Regional Tax, IR-INT-98-6 (Mar. 31, 1998). Under the relevant provisions of the Internal Revenue Code, sections 901 and 903, a foreign tax credit is allowed only for "income, war profits, and excess profit taxes" and for taxes paid in lieu of a tax on income, war profits, or excess profits. To qualify as an income tax under section 901, a tax must be likely to reach net gain by generally permitting the recovery of significant costs and expenses against gross receipts. Treas. Reg. § 1.901-2(b)(4)(1). To qualify as an "in lieu" tax subject to a credit under section 903, a tax must operate as a tax imposed in substitution for a generally imposed income tax. Treas. Reg. § 1.903-1(b)(i). Although the IRS did not explain the reasoning for its position that IRAP is not a creditable tax, it likely reached this conclusion because IRAP denies a deduction for labor and interest expenses, and because it entirely replaces, rather than substitutes for, ILOR.

[71] Mutual Agreement Between United States and Italy on Partial Creditability of Italian Regional Tax, *supra* note 71.

[72] Article 23(2)(c) of the treaty.

[73] Technical Explanation, article 23.

with U.S. policy for a treaty to guarantee the creditability of a portion of what otherwise might be a noncreditable foreign levy. The Joint Committee did note that the IRAP provision is not entirely unprecedented; U.S. treaties with Kazakhstan and the Ukraine require those countries to modify their internal law to provide for deductions for interest and labor costs in the case of certain U.S. persons, and provide for the creditability of the taxes as so modified. The U.S. treaty with Russia also requires Russia to provide interest and labor cost deductions in order to assist U.S. taxpayers seeking eligibility of Russian taxes for credits against U.S. income. However, the treaty does not guarantee that the Russian tax is creditable for U.S. purposes[74].

Rather than requiring Italy to provide an actual deduction for labor and interest expense, the IRAP provision in the treaty calculates a hypothetical portion of the IRAP tax actually imposed that would resemble a creditable income tax under U.S. principles. At the time of the treaty signing, this type of calculation had never appeared in any other U.S. treaty, and the Foreign Relations Committee strongly recommended that such hypothetical calculations not be used in the future[75]. The Committee recognized that special circumstances existed with respect to IRAP and expressed concern that the change in Italian law could unfairly disadvantage U.S. enterprises doing business in Italy, but it emphasized that the treaty calculation should not be construed as a precedent for future treaties to provide creditability for otherwise non-creditable taxes such as value added taxes. This advice appears to have been heeded, as no subsequent U.S. treaty contains a similar provision.

B. *Resourcing Rules*

The new treaty significantly clarifies the rule in the 1984 U.S.-Italy treaty that income must be resourced to Italy to the extent needed to prevent double taxation when a resident of Italy is subject to worldwide U.S. taxation by reason of U.S. citizenship[76]. With respect to items of income subject to a reduced rate of U.S. tax when derived by a resident of Italy who

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[74] Joint Committee on Taxation, Explanation of Proposed Income Tax Treaty and Proposed Protocol Between the United States and the Italian Republic (JCS-9-99), Oct. 8, 1999, at p. 59.

[75] Senate Foreign Relations Committee Report at p. 9.

[76] Article 23(4) of the 1984 U.S.- Italy treaty. The saving clause in Article 1(2)(b) permits the United States to tax its citizens on worldwide income even if they reside in Italy

is not a U.S. citizen, the amount of U.S. tax that Italy must credit is limited to the amount that would be collected in those circumstances[77]. The United States must provide a credit for taxes paid to Italy after the Italian credit, but it may collect any residual tax due by reason of the taxpayer's U.S. citizenship[78]. These provisions are consistent with both the 1996 and 2006 U.S. Model treaties.

V. *Conclusion*

The new treaty between the United States and Italy comes into force in something of a time warp. There are no precedents in the United States for a ten-year delay between Senate approval of a treaty and the treaty's entry into force. Necessarily, much of the new treaty is already out of date and will require revision before long. It will be most interesting to see whether the United States and Italy will move promptly toward a modernization of the new agreement.

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[77] Article 23(4)(a) of the treaty.
[78] Article 23(4)(b) of the treaty.