



ITALY TAX ALERT

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ITALIAN TAX AUTHORITIES CHALLENGE THE ADEQUACY OF THE ITALIAN PERMANENT ESTABLISHMENTS OF FOREIGN BANKS FREE CAPITAL

In recent time, Italian tax authorities are becoming more aggressive in challenging the deductibility of interest expenses at the level of Italian permanent establishments (“PE”) of foreign banks.

In principle, Italian permanent establishments of foreign banks are allowed to deduct the amount of passive interest paid on the loans granted by the headquarter. However, Italian Tax Authorities stated that the amount of the free capital assigned to the PE should be “appropriate” under the arm’s length principle, with the consequence that:

- a) any excess in the debt/equity ratio could imply a requalification from a mere tax perspective of granted loans as not interest bearing capital injection; and,
- b) passive interest paid upon the exceeding loans could be considered not deductible expenses.

From a practical standpoint, Italian Tax Authorities state that the amount of the free capital (not interest bearing) of the Italian PE should be in line with the amount ordinarily required for an Italian bank under the Bank of Italy surveillance provisions.

Based on that, where the Italian permanent establishment has a lower free capital, any loan granted by the headquarter should be considered as a further capital injection, with the consequence that the related passive interest paid on the loan are considered not deductible.

Tax Authorities ground their assessments on the OECD “Report on the Attribution of Profits to Permanent Establishments” (2010) where, among the others method to determine the free capital needed to fund the assets and support the risks attributed to the PE¹, OECD identified also the “*quasi thin capitalization approach*” (or regulatory minimum capital approach).

Under this approach, the PE should have at least the same amount of “free” capital required for regulatory purpose to an independent banking enterprise operating in the host country. Italian tax authorities ordinarily make reference to the Bank of Italy regulation and Circular letter n. 263/2006, and in particular to the “Core Tier 1” computation.

¹ Among the others methods:

- The *capital allocation approach*, seeking to allocate to the PE a free capital proportional to the assets and risks attributed to the PE, as resulting from a proper functional analysis;
- *Thin capitalization approach*, is based on the identification of comparable banks carrying on similar activities under the same or similar conditions in the Country where the permanent establishment is set up. Third parties banks are ordinarily identified with a strict functional and comparability analysis.

However, it is important to underline that OECD states that the quasi thin capitalization approach “*is not an authorized OECD approach as it ignores important internal conditions of the authorized OECD approach, e.g. that the PE generally has the same creditworthiness as the enterprise as a whole. However, it may be acceptable as a **safe harbor** as long as it does not result in the attribution of more profits to the PE than would be attributed by an authorized OECD approach.*”

As a consequence, in the OECD opinion, Italian permanent establishments could demonstrate to the Tax Authorities that their free capital, as determined by the headquarter, is actually appropriate and congruous with the activities carried out by the Italian PE, the assets used and the risks undertaken. This could be done making reference to the other approaches identified by the OECD Report.

We remain at your disposal for any clarification on the above.



Antonio Tomassini

T +39 02 80 618 1

antonio.tomassini@dlapiper.com



Carlotta Benigni

T +39 02 80 618 1

carlotta.benigni@dlapiper.com

www.dlapiper.com



@DLA_Piper_Italy

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