

World Tax Advisor

International Tax Developments
February 2001

FEATURE ARTICLE

Italy Introduces CFC Legislation

AROUND THE WORLD

AUSTRIA

New Tax Legislation for 2001

CANADA

Treatment of Delaware Partnerships Updated

Draft Legislation Released

CHINA

Withholding Tax Rate Reduced

CZECH REPUBLIC

Income Tax Act Amended

FRANCE

New Rules to Transfer the Avoir Fiscal

HONG KONG

Tax Collection Measures May be Intensified

ITALY

Budget Provisions Encourage Enterprise

KOREA

Proposed Transfer Pricing Amendments

RUSSIA

Tax Reform Enacted

SPAIN

Recent International Tax Amendments

UNITED STATES

Treasury Releases Subpart F Study

Subpart F Income on Asset Sale Not Avoided

Hyperinflationary Currency Base Period Changed

Victory in Harbor Maintenance Tax Case

Italy Introduces CFC Legislation

Marco Giuliani

Milan

Telephone: +39 (2) 8801 563

The Italian Parliament recently approved a bill introducing controlled foreign company (CFC) legislation. The new rules are likely to be effective from 1 January 2002. The regime introduces, for the first time, the accrual method instead of the cash method for profits earned by a CFC if certain conditions are met. In particular, from January 2002, profits earned by a CFC located in a tax haven country will be imputed to the Italian resident parent company or individual shareholder regardless of whether there is an actual dividend distribution.

The CFC rules apply to public and private entities (whether or not of a commercial nature), Italian resident partnerships, limited companies, co-operatives and individuals. The rules also apply to shareholdings in CFCs that are held directly or indirectly by the Italian resident, including holdings through intermediaries and fiduciary companies.

Meaning of Control

The first requirement for application of the CFC rules is that the Italian resident taxpayer control the CFC. Contrary to the provisions of the first draft of the legislation, which made reference to a minimum shareholding of 25% in the CFC's share capital, the final text of the law does not provide for any minimum percentage of ownership. It states that the CFC rules will apply only if a foreign entity is "controlled," as defined in article 2359 of the Italian Civil Code. The reference to the Civil Code was necessary because there is no specific provision defining control for tax purposes. According to the Civil Code, an entity controls another company if it:

- 1) possesses more than 50% of the voting rights at the ordinary shareholder meetings;
- 2) has sufficient voting rights to exercise a dominant influence at the ordinary general meeting of the foreign entity; or
- 3) can exert influence on the foreign company because of certain contractual arrangements.

Item (3), above, should not be considered in applying the CFC provisions because it would be difficult to impute profits to the resident shareholder in the absence of direct or indirect ownership. The law also provides that, in determining the amount of profits to be subject to Italian tax, reference must be made to stock ownership, voting rights and other rights to profit distributions.

The intentional lack of a specific ownership threshold enhances the Italian tax authorities' ability to combat tax avoidance even though the CFC regimes in many European countries (*e.g.* Finland, Germany, Portugal, Spain, Sweden and

ness analysis to challenge transactions that, in its view, are simply a subpart F avoidance technique. By checking the box on the lower-tier CFCs to be disregarded as separate entities, the transactions are designed as sales of the lower-tier CFCs' assets, not the stock of those lower-tier CFCs. Accordingly, the US shareholder avoids subpart F treatment on the income generated by the sale. For the moment, electing disregarded status as early as possible, and, if feasible, with a retroactive effective date that precedes the commencements of negotiations to sell, should reduce considerably the risk of a challenge since the upper-tier CFC would have held the assets before forming the intent to sell.

If and when the proposed "extraordinary transaction" regulations are finalized the IRS would have no need to resort to the trade or business analysis since the regulations essentially establish a *per se* rule that denies asset sale treatment to the transaction. As provided in the proposed regulations, if the "extraordinary transaction" (disposition of a 10% or greater interest in the disregarded entity) takes place within a period commencing one day before and ending 12 months after the effective date of the change of classification, the election is retroactively nullified and the transaction is treated as a sale of stock.

If business considerations seem to indicate that a sale of a CFC is desirable, careful planning should be employed to avoid the patterns described in these determinations.

Hyperinflationary Currency Base Period Changed

Mary Heinzerling & Jeff O'Donnell
Washington, DC
Telephone: +1 (202) 220-2074
Telephone: +1 (202) 879-4932

Final regulations, issued on 29 December 2000 and effective for all transactions entered into after 14 February 2000, define "hyperinflationary currency" for purposes of computing foreign currency gain and loss under § 988. In general, the final regulations provide that, for these purposes (but not for purposes of the dollar approximate separate transactions method or other foreign currency provisions, such as §§ 985-989), the definition of a hyperinflationary currency is a currency of a country that has experienced a cumulative rate of inflation of at least 100% over the 36-month period ending on the last day of the taxpayer's current tax year.

Base Period Redefined

In defining hyperinflationary currency, the final regulations generally adopt the definition of hyperinflationary currency found in the functional currency regulations. That provision identifies hyperinflationary currency by utilizing as the base period the 36-month period *preceding the first day* of the taxpayer's current tax year, however. The Treas-

ury believed that using the base period defined in the functional currency regulations for purposes of determining currency gains and losses under § 988 may not clearly reflect a taxpayer's income and expense since dramatic changes in inflation may occur during the taxpayer's current tax year. Accordingly, the final regulations provide that the relevant base period for § 988 foreign currency gain or loss purposes will be the 36-month period *ending on the last day* of the taxpayer's current tax year.

RICs and REITs

The revised base period may cause administrative burdens to regulated investment companies (RICs) and real estate investment trusts (REITs), since both types of entities have rules requiring the distribution of income earned in the current tax year. For this reason, the final regulations provide that the revised base period will not apply to RICs, REITs or any other entity identified by IRS notice that has distribution requirements similar to RICs or REITs. Instead, such entities will continue to use the general base period defined in the functional currency regulations.

GAAP Cannot Alter § 988 Base Period

The functional currency regulation definition allows a taxpayer to use generally accepted accounting principles (GAAP) for determining a hyperinflationary currency for certain foreign currency transaction purposes (if the GAAP standards are similar to those outlined in the regulations). The final § 988 regulations, however, specifically prohibit the use of GAAP to change the base period for § 988 purposes.

Victory in Harbor Maintenance Tax Case

Damon Pike, Keun Ho Bae & Dick Rose
Atlanta & Detroit
Telephone: +1 (404) 220-1119
Telephone: +1 (404) 220-1255
Telephone: +1 (313) 396-3693

The US Supreme Court delivered a major victory for US exporters by recently denying the government's petition for review in *Swisher Int'l v. United States*. As a result, US exporters may be entitled to refunds of the Harbor Maintenance Tax (HMT) collected by the US Customs Service on exports of goods shipped via ocean freight since 1987.

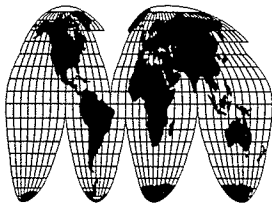
In the *Swisher* case, the US Court of Appeals for the Federal Circuit (CAFC) ruled that exporters may use administrative procedures to claim refunds of the HMT, and that these procedures do not impose a time limit within which HMT refunds may be claimed. In essence, the CAFC's decision allows exporters to apply for refunds dating to the 1987 inception of the HMT. The

HMT is levied as a percentage of the value of exported goods, which most recently was set at 0.125% of the cargo's value. (The HMT was collected at a slightly higher rate when first imposed in 1987.)

The HMT has been in litigation since 1995, when a US exporter first sued the government over the constitutionality of the tax. According to the "Export Clause" of the US Constitution, "[n]o tax or duty shall be levied on Articles exported from any State." After working its way through the lower courts, the Supreme Court unanimously ruled on 31 March 1998 that the HMT was indeed a "tax" versus a "user fee" as urged by the government and, thus, subject to the Export Clause's prohibition. The only questions that remained open subsequent

to this unanimous decision were: (1) how far back exporters could claim refunds, given that the lower court decision imposed a two-year statute of limitations (this issue was not addressed in the initial Supreme Court decision); and (2) whether interest was owed to exporters on refunds paid.

The first of these questions has now been answered with finality by the *Swisher* case. The second, regarding interest, was answered "no" by the CAFC in another case, *IBM v. United States*, but IBM recently filed a petition for review with the Supreme Court. Thus, the second issue is still open until the Supreme Court resolves it by either denying the petition or granting it, hearing the case on its merits and issuing a final decision.



If you have any questions concerning the items in this month's newsletter, please contact one of the tax professionals at a Deloitte Touche Tohmatsu office in your area or email slyons@deloitte.com or aafalonis@deloitte.com.

World Tax Advisor is a bulletin of international tax developments prepared by the professionals of Deloitte Touche Tohmatsu. It is intended as a general guide only, and the application of its contents to specific situations will depend on the particular circumstances involved. Accordingly, we recommend that readers seek appropriate professional advice regarding any particular problems that they encounter, and this bulletin should not be relied on as a substitute for this advice. While all reasonable attempts have been made to ensure that the information contained in this newsletter is accurate, Deloitte Touche Tohmatsu accepts no responsibility for any errors or omissions it may contain, whether caused by negligence or otherwise, or for any losses, however caused, sustained by any person that relies on it.

© 2001 Deloitte Touche Tohmatsu. All rights reserved. Printed in the United States of America.

**Deloitte
Touche
Tohmatsu**