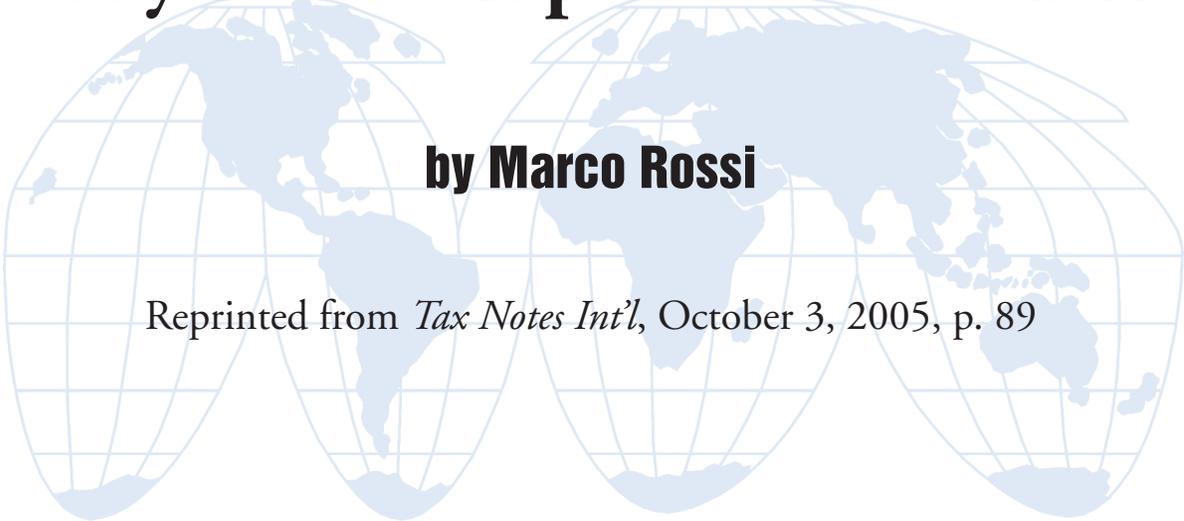


Italy's Thin Capitalization Rules

by Marco Rossi

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As part of the 2003 corporate and international tax reforms that took effect in 2004, Italy has adopted new rules limiting a corporate or individual taxpayer's ability to deduct interest on debt directly or indirectly held or guaranteed by a qualified shareholder or its related parties. Qualified shareholders are shareholders that control the borrower or hold more than 25 percent of the borrower's stock (including stock owned by related parties). Related parties are companies controlled by a qualified shareholder.

The rules apply when the borrower's debt-to-equity ratio exceeds 4 to 1, both at the level of the single qualified shareholder and at the aggregate level of all qualified shareholders (and their related parties) holding or guaranteeing the related borrower's debt.

The borrower can avoid the application of the rules by proving that the financing was obtained through its own borrowing capacity and not as a result of its relationship with the related-party lender or guarantor.

Nondeductible interest paid or accrued on debt directly held by a qualified shareholder or its related parties is recharacterized as dividend for Italian income tax purposes. At the domestic level, the deemed dividend is exempt from Italy's corporate income tax under the participation exemption rules. At the international level, it is subject to higher withholding tax (27 percent) reduced by any applicable treaty, but never to zero and usually not to the same extent as the treaty reduction of interest withholding tax, unless paid to an EU parent company that is exempt from withholding tax under the EC parent-subsidiary directive.

Originally Italy's new earnings-stripping rules were designed to apply only to cross-border related-party interest (much like the U.S. earnings stripping rules of IRC section 163(j)).¹ However, during

the process of approval of the tax reform bill, the European Court of Justice issued its ruling in the *Lankhorst-Hohorst* case. The ECJ struck down German earnings-stripping rules on the basis that they applied primarily to nonresident lenders and created an unlawful discrimination between resident and nonresident taxpayers established in other EU member states in violation of the EC Treaty.² To avoid a similar violation of the antidiscrimination provisions of the EC Treaty, the Italian government in the process of approving the bill amended the rules. They now apply equally to domestic and cross-border related-party financing.³

The new rules are set out in Tax Code section 98 and are commonly referred to as the Italian thin capitalization rules. The Italian tax administration provided administrative guidance on the interpretation and application of those rules with Circular 11/E issued on March 17, 2005. The thin capitalization rules are specifically coordinated with other antistripping provisions of Italian tax law.

government to issue rules limiting the deductibility of interest paid to a qualified shareholder or related person when the borrower's debt-to-equity ratio exceeds a stated threshold, but only if the interest would not be part of income subject to tax in Italy on a net basis. That is usually the case when interest is paid to a resident lender (or a permanent establishment of a nonresident taxpayer). Therefore, according to the authority granted by Parliament to the government, domestic interest would not have been subject to the rules.

²In 2002 the ECJ ruled in the *Lankhorst-Hohorst* case that Germany violated the principle of freedom of establishment in applying its thin capitalization rules to disallow interest paid by a German company to its indirect Dutch parent company. The German thin capitalization rules did not apply to interest paid to a German parent. That result was achieved indirectly by a rule providing that interest is nondeductible unless paid to a taxpayer entitled to an imputation credit, which is typically a resident taxpayer. That decision invalidated the thin capitalization regimes of several EU member states. Those states amended their laws to remove the discriminatory element, either by repealing the thin capitalization rules altogether or, as Germany did, by expanding their scope to payments to resident lenders as well. Italy was in the process of approving its own thin capitalization rules at the time of the ECJ decision and decided to implement them nevertheless, but to extend their coverage to domestic interest payments.

³One could argue whether the rules may be invalid to the extent that they apply also to domestic related-party financing transactions, going beyond the limits of the authority granted by Parliament to the government with Law 80 of 2003; see note 1.

¹Article 4(1)(g) of Law 80 of Apr. 4, 2003, which delegated to the government the authority to reform various aspects of Italian corporate and international tax rules, authorized the

(Footnote continued in next column.)

Italy's thin capitalization rules are based on facts-and-circumstances tests that need a great deal of inquiry and leave much to interpretation. They are still affected by some areas of uncertainty, apply together with other Italian antistripping provisions that need to be coordinated, and ultimately create a significant administrative burden both on taxpayers and the tax administration. The new rules are effective for tax years beginning after January 1, 2004. In particular, foreign taxpayers engaged in transactions or operations that involve highly leveraged Italian subsidiaries need to pay specific attention to them to avoid unfavorable tax consequences.

Part I of this article focuses on Italy's new thin capitalization rules. The topics discussed are: (1) the taxpayers subject to the rules; (2) the scope of the rules; (3) the definition of key terms (qualified shareholder, related party, debt, guaranty, and interest); (4) the general and specific debt-to-equity ratios that determine the application of the rules; (5) the computation of nondeductible interest; (6) the recharacterization of nondeductible interest as dividends; and (7) the general exception to the rules represented by the borrower's own credit capacity. Part II briefly illustrates the other Italian antistripping rules that apply concurrently with the thin capitalization rules, and discusses how they are coordinated with the thin capitalization rules to avoid overlap.

I. The Thin Capitalization Rules

A. Taxpayers Subject to the Rules

The rules are very wide in scope and apply to resident corporations, partnerships, sole proprietorships, and permanent establishments in Italy of foreign entities of any types. More precisely, taxpayers subject to the rule are:

- joint stock companies (*Società per Azioni*, SPAs), limited liability companies (*Società a Responsabilità Limitata*, SRLs), limited partnerships with capital divided by shares (*Società in Accomandita per Azioni*, SAPAs), limited liability cooperative companies (*Società Cooperative a Responsabilità Limitata*, SCARLs), mutual insurance companies, and commercial consortia;⁴
- state or private organizations whose exclusive or primary activity is a trade or business;
- state or private organizations whose exclusive or principal activity is not a trade or business, on their unrelated business taxable income (if any);

⁴All of those entities are classified as corporations for Italian tax purposes and are subject to Italian corporate income tax.

- nonresident entities of any type, with or without legal personality, regardless of their classification and tax treatment under foreign law, on interest attributable to their PE(s) in Italy;⁵
- resident general partnerships (*Società in Nome Collettivo*, SNC);
- resident limited partnerships (*Società in Accomandita Semplice*, SAS); and
- resident sole proprietorships and family enterprises.⁶

Interestingly, a nonresident sole proprietorship is not subject to the rules.

Taxpayers whose revenue for the current tax year does not exceed the limit provided for in the application of the so-called area surveys or *studi di settore* are not subject to the rules.⁷ The general limit for the application of the *studi di settore* is €5,164,569 (about US \$6.3 million).⁸

Companies engaged in a banking or financing business (as defined by article 1 of Legislative Decree n. 87 of 1997) also are not subject to the rules. However all holding companies, including banking or financing holding companies, are always subject to the rules regardless of the revenue limitation.⁹ For that purpose, holding companies are companies

⁵Under the Italian source of income rules, interest paid by a PE in Italy of a nonresident taxpayer is Italian-source income (Tax Code section 23) and is subject to withholding tax. The PE pays interest if the legal liability for the interest falls on the PE, even though the remainder of the company makes the material payment.

⁶The first four categories of taxpayers are entities classified as corporations and subject to Italy's corporate income tax and are referred to by Tax Code section 98. Tax Code section 56 and 63 extend the thin capitalization rules also to partnerships and sole proprietorships.

⁷The so-called *studi di settore* are special surveys conducted from time to time on different areas of business or professional activities, by means of which the tax administration collects specific data and information concerning those activities, elaborates on them, and sets out various income brackets with reference to which it selects the taxpayers subject to audit and conducts the audits.

⁸To that effect, revenue includes only gross receipts derived from taxpayer's typical business activity, excluding financial income referred to under Tax Code section 85(c), (d), and (e) (that is, gains from sale of stock, participating financial instruments characterized as stock, and debt obligations held as inventory or stock-in-trade). Extraordinary income items are also excluded from the computation. If revenue is adjusted on audit, reference is to be made to the higher amount of income assessed at audit. For companies created during the tax year, the revenue computation is made pro rata. The ratio of that provision is to exclude small to mid-size businesses from the application of the thin capitalization rules.

⁹Tax Code section 98(7).

whose exclusive or principal business activity is that of holding shares in other companies.¹⁰

B. Scope of the Rules

The rules apply to interest paid or accrued on debt directly or indirectly held or guaranteed by a qualified shareholder or any of its related parties. The key terms for the application of the rules (“qualified shareholder,” “related parties,” “debt,” “guaranteed,” and “interest”) as defined in the statute are illustrated in section I.C below.

However, neither the statute nor the administrative guidelines provide any clarification of the meaning of “indirectly.” That leaves significant discretion to the taxing authority and creates uncertainty for taxpayers (and their tax advisers). It would seem reasonable to argue that the term embraces back-to-back loan or guarantee agreements whose sole or principal purpose is that of avoiding the application of the rules. However, it is not equally clear whether it would include bona fide and business-motivated triangular arrangements.

C. Definitions

1. Qualified Shareholder

Tax Code section 98(3)(c) provides that the term “qualified shareholder” includes any shareholder who:

- directly or indirectly controls the borrower (control test); or
- owns 25 percent or more of the borrower’s stock (stock ownership test).

The definition of qualified shareholder would appear to be two-pronged. First, it requires that there be a shareholder under the general concepts of corporate law. Second, it requires that the shareholder be qualified under either the control or the stock ownership test.¹¹ On the face of the statute, the starting point to meet the definition of qualified shareholder seems to be establishing that a person holds the status of shareholder under the general concepts of corporate law. That requires that a person own directly at least a fractional share of the borrower’s stock. As we will see below in the context of the illustration of the control test, control may be indirect and may exist without any (direct or indirect) ownership of the borrower’s stock. Moreover, any stock of the borrower owned by a controlled entity is attributed in full to the controlling entity

under the stock ownership test. However, the status of the shareholder still requires direct ownership of at least a fractional share of the borrower’s stock. If this reading of the statute is correct, then if a related person lender or guarantor controls the borrower through other entities or constructively owns more than 25 percent of the borrower’s stock (thereby meeting the qualified part of the definition of qualified shareholder under either the control test or the stock ownership test) but does not directly own at least a fractional share of the borrower’s stock, it would not be a shareholder, the qualified shareholder definition would not be met, and the rules theoretically would not apply.¹²

All holding companies, including banking or financing holding companies, are always subject to the rules regardless of the revenue limitation.

That conclusion, based on the literal language of the statute, reveals a potential loophole in the rules. The underlying ratio of the provisions on constructive ownership and indirect control suggests otherwise and supports the conclusion that the definition of qualified shareholder would be met for the purpose of application of the rules even without direct ownership of the borrower’s stock if either the control or stock ownership test is satisfied.¹³

¹²Circular 11/E does not contain any specific clarification on point. When it illustrates the stock ownership test that applies to determine whether the shareholding is a “qualified” shareholding, it reiterates that stock indirectly owned through controlled companies is added to stock owned directly by the shareholder to see whether the 25 percent threshold is met. It then considers a situation in which a shareholder owns directly less than the minimum amount of stock, but more than 25 percent of stock if including stock owned through controlled companies. Therefore, it satisfies the test. In both cases it implies that there is a direct ownership of at least some of the borrower’s stock. However, it never expressly considers a situation in which there is no direct ownership of at least a fractional share of the borrower’s stock.

¹³A passage in Circular 11/E, even if out of context and inconsistent with the language of the statute, would seem to support that conclusion. At paragraph 3.2, while illustrating the concept of party related to a qualified shareholder (related party), at a particular point it states that the status of qualified shareholder can be achieved even in the absence of a direct participation in the borrower’s stock and, in that case, for the purpose of computing the shareholder’s specific debt-to-equity ratio, the stock owned by the indirect shareholder is presumed to be the total of borrower’s stock. One would have expected a reference to the concept of related party, for which that conclusion holds true. Because (1) the passage is part of

(Footnote continued on next page.)

¹⁰They are identified on the basis of the factors set out in article 2 of Ministerial Decree of July 6, 1994, as clarified in Ministerial Circular 141/E of June 4, 1998.

¹¹For partnerships or entities other than stock companies, the term “shareholder” is used in substitution for the term “partner” or “member of the entity.”

Circular 11/E clarifies that for sole proprietorships the term “shareholder” must be deemed to refer to the owner of the enterprise and, for family enterprises, also to particular family members (spouse, grandparents and grandchildren, brothers and sisters). Circular 11/E also clarifies that for foreign entities’ PEs in Italy the term is deemed to refer to the foreign entity’s qualified shareholders. It does not include the remainder of the foreign entity. Therefore, infra-entity-financing dealings fall beyond the scope of the rules.

a. Control Test

Under the control test, a qualified shareholder is a shareholder who directly or indirectly “controls” the borrower.

The Italian tax administration usually relies on the PE’s books and records but is authorized to disregard them if they do not reflect the economic reality.

Control is defined with reference to the provisions of Italian corporate law that defines the notion of controlled company for corporate law purposes. Section 2359(1) of the Italian Civil Code provides that control exists in each of the following three situations:

- ownership of more than 50 percent of the votes that can be exercised at the shareholder’s ordinary meeting (which elects company’s directors);
- ownership of a sufficient number of votes to exercise a dominant influence at the shareholder’s ordinary meeting; or
- the ability to exercise a dominant influence at the shareholders’ ordinary meeting as a result of specific contractual relationships or arrangements.

the illustration of the concept of related party and is fit for the notion of related party, but not for that of qualified shareholder, (2) no similar language is contained in the part of the circular that illustrates the concept of qualified shareholder, and (3) the statutory definition of qualified shareholder is inconsistent with this clarification, and the issue may be considered still open. The courts may want to cover that potential loophole by going beyond the literal language of the statute and relying on the general ratio of the rules that is clearly meant to include situations of indirect control and entirely constructive ownership of borrower’s stock. However, there is no case law on point, and as we have seen the only guidance provided by the tax administration does not completely clarify the issue.

Section 2359(2) of the Italian Civil Code provides that, for purposes of the voting power test of the first and second situations above, votes owned through controlled companies,¹⁴ fiduciary companies, and conduits are also included in the computation (indirect or constructive voting power rule).

According to the statutory definition of Tax Code section 98, control can also be indirect (indirect control rule). However, neither the statute nor Circular 11/E clarify the exact meaning of that rule. One interpretation may be that control, either based on voting power (the first and second situations) or contractual relationships (the third situation) is attributed in full from a lower-tier controlling member to an upper-tier controlling member of the same group of controlled companies along the chain and up to the ultimate parent. Another interpretation may be that control so defined is attributed to the members of the groups in proportion to the stock that each of them directly or indirectly owns in a related entity. It is also unclear whether attribution would take place with no direct ownership merely on the basis of the existence of a factual control under section 2359(1)(iii) of the Civil Code.

b. Stock Ownership Test

Under the stock ownership test, a qualified shareholder is a shareholder that owns at least 25 percent of the borrower’s stock. Stock means capital or equity interest in the borrower. Stock may be of any type — common or preferred, limited as to dividends or liquidating distributions or participation to losses, voting or nonvoting or with limited or contingent voting rights or power to vote only on some matters, as permitted under company law. Participating financial instruments that are classified as stock for tax purposes but are not stock for corporate law purposes are not included.¹⁵

Stock owned by a shareholder’s related parties (that is to say, companies controlled by a qualified shareholder within the meaning of Civil Code section 2359) is attributed to the shareholder in full and added to the stock owned directly by the shareholder for the purpose of that test.¹⁶

¹⁴Under the meaning of Civil Code section 2359 as described above.

¹⁵Reference is made to the participating financial instruments that can be issued by SPAs as per articles 2346 and 2349 of the Italian Civil Code. Those instruments represent a participation to the profits of the issuer and are issued in consideration of an at-risk contribution of property or services to the company, but do not attribute the status of shareholder in that they do not entitle the holder to exercise control and share in net assets upon liquidation.

¹⁶Tax Code section 98(3)(c)(2). It is in that context that Circular 11/E states that, on the basis of that provision, a shareholder directly owning less than 25 percent of the

(Footnote continued on next page.)

2. Related Parties

The thin capitalization rules apply also to interest on debt held or guaranteed by a party related to a qualified shareholder (related party).

As illustrated above, the borrower's stock (under the stock ownership test), voting power (under the indirect voting power rule), and perhaps control of the borrower (under the indirect control rule) held by a related party is attributed to a controlling shareholder for determining its status as a qualified shareholder of the borrower relevant for the application of the rules. Related parties are companies controlled by a qualified shareholder within the meaning of Civil Code section 2359, and, for an individual shareholder, some family members (spouse, grandparents, grandchildren, and siblings). For that purpose, control is determined under the same rules of Civil Code section 2359 illustrated in section I.C.1.

3. Disqualified Debt

The thin capitalization rules apply to debt held or guaranteed by a qualified shareholder or its related parties (disqualified debt).

For that purpose, the term "debt" includes money or other property advanced under a loan, cash, or securities deposit or any other arrangements of financial nature whose purpose is extending credit or granting the use of money.¹⁷ Debt does not include trade or service receivables, unless the terms of the transaction (for instance, a price exceeding the fair market value of the goods or services rendered and a very long payment date) are so different from the common practice that they dissimulate a loan. When the status of a qualified shareholder or related party is acquired or lost during a fiscal year, debt held or guaranteed by a shareholder or a related party before acquiring the status of qualified shareholder or related party is taken into account from the date on which the lender or guarantor has acquired the status of qualified shareholder or related party, and until the date it loses this status and is computed pro rata. Interest-free loans are excluded provided that the average remuneration on interest-bearing

borrower's stock may be a qualified shareholder if after computing the borrower's stock owned by any of its related parties, it holds more than 25 percent of the borrower's stock. It points out that for computing the total stock owned by a shareholder and its related parties, the stock owned by the latter is computed in full (and not only in proportion to the stock that the shareholder owns in each of its related parties owning borrower's stock). That is still not sufficient to conclude that the definition of qualified shareholder can be met even without achieving first the status of shareholder, that is, without directly holding at least a fraction share of the borrower's stock, for the reasons explained in section I.C.1.

¹⁷Tax Code section 98(4).

loans made or guaranteed by the same qualified shareholder or related party does not exceed the official discount rate (at the time of this writing, 2 percent) plus 1 percent.¹⁸

Circular 11/E clarifies that for PEs in Italy of a nonresident entity, the rules apply to debt attributable to the PE. If a direct allocation or tracing is not possible, they apply to a portion of the foreign entity's overall debt apportioned to the PE on the basis of the ratio of gross profits of the PE over the total gross profits of the entity. No specific criteria are set forth for allocating debt to a PE. Reference could be made to article 11 of the OECD model treaty, according to which a debt is attributable to the PE if it is incurred for the purposes of the PE's trade or business and is borne by the PE (that is, it is paid out of its own funds) and interest paid or accrued thereon is deductible from the PE's Italian income. The Italian tax administration usually relies on the PE's books and records to establish whether a debt is attributable to a PE, but is authorized to disregard them and look to the substance of the transaction if they do not reflect the economic reality.

Circular 11/E discusses some specific arrangements. Zero balance cash pooling transactions are not covered by the rules, because reciprocal debits and credits are entirely offset and there is no repayment obligation on the parties to the transaction that therefore does not constitute a loan or financing arrangement. Notional cash pooling transactions are covered by the rules in that they consist in a loan. Similarly, an operative lease transaction is not included, while a financial lease is included because it is also equivalent to a loan.¹⁹ In that case, the interest component of the lease payments must be computed separately and is subject to the rules.

Loans taken out for a banking or financing business by banks and other financial institutions do not fall within the scope of the rules.²⁰ However, debt of

¹⁸Circular 11/E illustrates an example in which the same qualified shareholder or its related parties make interest-free loans for 1,000x and interest-bearing loans for 1,000x at the average interest rate of 4.5 percent. Because the interest rate on interest-bearing loans exceeds the official discount rate plus 1 percent (3 percent), the interest-free loans are computed in full for the purposes of the application of the thin capitalization rules.

¹⁹For a distinction between the two types of leases, see Circular 11/E, which refers to IAS 17 and Ministry of Economy and Finance resolution 19/E of Feb. 23, 2004, which allows the separate computation and deduction of the constructive interest of a finance lease if the lease payments are nondeductible.

²⁰Entities covered by the exceptions are those enumerated in article 1 of Legislative Decree 87 of Jan. 27, 1992, namely:
(Footnote continued on next page.)

banking or financing holding companies is always covered by the rules. For that purpose, a banking or financing company is a holding company if its exclusive or principal activity is holding shares of stock of another company, as opposed to typical operational banking activities like extending credit or loans and providing treasury, currency exchange, and intermediation services.²¹

Operating profits must remain undistributed through the end of the fiscal year to which the rules may apply to enter into the net equity computation.

The thin capitalization rules apply also to debt held by a third party but guaranteed by a qualified shareholder (or its related parties). For that purpose, the term “guaranteed” includes any type of guaranty arrangements contemplated by law like mortgages, pledges, or personal guarantees, as well as any other acts or behavior that in the commercial and business practice are commonly relied on by a lender to grant a loan or extend credit and have the economic effect of a guaranty. Circular 11/E mentions the patronage letter as an example. A pledge of shares whose purpose is not that of obtaining the extension of credit, but giving control or the voting rights to the lender is not a guaranty.²² Circular 11/E clarifies that if two or more qualified shareholders are jointly and severally liable under the terms of the guaranty, the debt is apportioned among them in proportion to their respective share of stock of the borrowing company (for purposes of computing the debt-to-equity ratio and the amount of disqualified debt and nondeductible interest for each of them). It does not clarify, however, if stock owned by the shareholder’s related parties is to be attributed to the qualified shareholder also for that purpose under the same attribution rules that apply for deter-

mining the status of a shareholder as qualified shareholder under the stock ownership test.²³ If, according to the terms of the guaranty, the liability is separate upon each of the qualified shareholders-guarantors, the debt is allocated in proportion to each shareholder’s share of debt undertaken under the guaranty. That clarification is important in that it allows a taxpayer to allocate the guaranty among members of the group to minimize the potential impact of the thin capitalization rules.

4. Interest

Interest includes imputed interest and original issued discount, as well as any other remuneration paid under the terms of the debt agreement in consideration for the extension of credit and the use of money granted thereunder. It also includes interest that has been capitalized and is part of the property’s adjusted tax basis under Tax Code section 110.²⁴

D. Debt-to-Equity Ratios

The rules apply if the ratio of borrower’s disqualified debt and borrower’s equity owned by borrower’s qualified shareholders and their related parties (debt-to-equity ratio) exceeds a particular threshold. Two separate calculations must be made. First, the debt-to-equity ratio must be computed at the level of all borrower’s qualified shareholders and their related parties (general debt-to-equity ratio). Then, the debt-to-equity ratio must be computed a second time, also at the level of each of the borrower’s qualified shareholder and their related parties (specific debt-to-equity ratio). In both cases, the ratio must exceed 4 to 1 (5 to 1 for the borrower’s first tax year).

1. General Debt-to-Equity Ratio

In the general debt-to-equity ratio, the numerator of the fraction is the total debt held or guaranteed by all qualified shareholders and their related parties. The denominator of the fraction is the total net equity of the borrower owned by those qualified

banks; investment funds managing companies (*Società di Gestione del Risparmio*, SGRs); finance parent companies of registered banking groups; savings intermediary companies (*Società di Intermediazione Mobiliare*, SIMs); financial entities carrying out a regulated financing activity (as per article 25 and 59 of the Unified Code of Laws in the Area of Credit and Finance (*Testo Unico delle Leggi in Materia Creditizia e Finanziaria*) approved with Law 142 of Feb. 19, 1992.

²¹For that purpose, Circular 11/E refers to the rules set forth in article 4 of the Ministerial Decree of July 6, 1994, as further clarified in Circular 141 of June 4, 1998.

²²That happens in some project financing transactions, when the pledge of the operating company’s shares in favor of the lending banks or financial institutions is aimed at enabling the lender to exercise control over the project and make sure that it is properly carried out as planned.

²³That problem arises when a debt is guaranteed by the qualified shareholder only, or by the qualified shareholder and only some of its related parties. The question is whether stock owned by any nonguaranteeing related parties of the guaranteeing shareholder must also enter into the computation.

²⁴Tax Code section 110 provides that interest can be capitalized and included in the adjusted basis of tangible or intangible property if it was reported on the balance sheet as part of the cost of the property in accordance with provisions of law. It can be included in the tax cost of real estate property held as inventory property if it relates to debt incurred for construction or improvement of the property and provided that it has been capitalized also for book purposes.

shareholders and related parties. The ratio must exceed 4 to 1, increased to 5 to 1 for the borrower's first tax year.

Neither the statute nor the circular are entirely clear on whether the denominator of the fraction must include the borrower's equity owned by all of the borrower's qualified shareholders and related parties, including those who do not hold or guarantee disqualified debt, or only the share of the borrower's equity owned by that borrower's qualified shareholders (and their related parties) that actually hold or guarantee disqualified debt. The example discussed by Circular 11/E does not help clarify that issue.²⁵

2. Specific Debt-to-Equity Ratio

In the specific debt-to-equity ratio, the numerator of the fraction is the debt held or guaranteed by each qualified shareholder (and its related parties) and the denominator of the fraction is the portion of borrower's net equity owned by that qualified shareholder (and its related parties). That ratio also must exceed 4 to 1, increased to 5 to 1 for the borrower's first tax year.

Nondeductible interest is recaptured by an upward adjustment to the book income on the basis on which taxable income is computed.

Because the rules on computation of debt and net equity as numerator and denominator of the fraction are the same for both the general and specific debt-to-equity ratios, we discuss them in the following paragraphs.

3. Computation of Disqualified Debt (Numerator)

The debt at the numerator of the fraction is the average amount of borrower's disqualified debt, that is, debt held or guaranteed by a qualified shareholder (or one of its related parties).²⁶ The amount of disqualified debt at the numerator of the fraction is

²⁵Circular 11/E considers a situation in which the total net equity owned by *all* qualified shareholders (and their related parties) amounts to 1,000x and the total debt held or guaranteed by *those* (that is, the same all) qualified shareholders (and their related parties) amounts to 3,000x, out of which the amount of 2,500x (that is, 80 percent of the total debt) has been granted by a qualified shareholder who owns 40 percent of the borrower's capital (400x). Because the general debt-to-equity ratio is (3,000x/1,000x) 3 to 1, the rules do not apply, even though the specific debt-to-equity ratio for the 40 percent shareholder is equal to (2,500x/400x) 6.25 to 1.

²⁶Tax Code section 98(3)(f).

computed by adding the amounts of disqualified debt outstanding on each day of the tax year, and dividing the total amount so obtained by the total number of days in the tax year. The days of the tax year on which a shareholder granting or guaranteeing that debt was not a qualified shareholder are disregarded.²⁷

4. Computation of Net Equity (Denominator)²⁸

The net equity at the denominator of the fraction is the book value of borrower's net equity as it appears from the borrower's financial statement for the prior financial year. Operating profits are included in the computation if they are still undistributed in the year of application of the thin capitalization rules. That means that any operating profits must remain undistributed through the end of the fiscal year to which the rules may apply to enter into the net equity computation. For PEs of nonresident entities, reference is to be made to the PE's net equity on the PE's books and records. For newly formed companies, reference is to be made to the company's net equity at the time of its formation or incorporation. Net equity so determined must be adjusted downward by the following:

- receivables for shareholder's equity contributions still outstanding;
- treasury stock (at book value) acquired in violation of the limits set forth in the Civil Code and that must be cancelled unless otherwise transferred or disposed of within one year from its acquisition;²⁹

²⁷Circular 11/E illustrates the rule by the following example. A loan of 100,000x is granted by a qualified shareholder on Jan. 1, 2004. A new loan of 50,000x is granted by the same qualified shareholder on June 1, 2004. Therefore, the outstanding debt held by a qualified shareholder during the tax year is 100,000x from Jan. 1, 2004 to May, 31, 2004 (152 days) and 150,000x thereafter (214 days). The total number of days in the tax year is 366. The total average amount of debt to be put at the numerator of the fraction is (100,000 X 152) + (150,000 X 214)/366 = 129,235x.

²⁸Tax Code section 98(3)(e).

²⁹Civil Code article 2357 provides that a company cannot purchase and hold its own shares of stock as treasury stock for a value exceeding the amount of profits and reserves of profits that result from the latest approved financial statement and the shares must be fully paid up. The face value of those shares of stock also cannot exceed one-tenth of the company's stock, computing also shares owned by controlled companies. The company's shares purchased in violation of those limitations must be disposed of within one year or must be canceled with a corresponding reduction of the company's paid-up capital. Civil Code section 2357-*bis* provides that the above rules do not apply to a redemption of shares executed to implement a reduction of capital by means of a buyback and cancellation of shares. Finally, Civil Code section 2357-*ter* provides that a nondistributable reserve for an amount equal

(Footnote continued on next page.)

- financial operating losses, unless covered by transferring accumulated profits to equity or making additional equity contributions within the second financial year following the year in which the loss was incurred;³⁰ and
- book value of shares of stock of controlled or related companies (book outside basis) or the value of the pro rata share of the underlying net assets (book net inside basis), whichever is lower.³¹

E. Nondeductible Interest Computation

Computation of nondeductible interest for each qualified shareholder (or related parties) is carried out in three steps. First, the portion of disqualified debt exceeding the permitted debt-to-equity ratio (excess debt) is computed. Second, the average interest rate on disqualified debt is determined. Third, the amount of nondeductible interest is computed by multiplying the qualified shareholder's (or related party's) excess debt by the average interest rate. We examine each element of the computation below.

1. Excess Debt

The excess debt for each qualified shareholder (or related party) is the portion of qualified shareholder's (or related party's) disqualified debt exceeding the qualified shareholder's (or related party's) specific debt-to-equity ratio. Interest-free loans are included in the computation if the average interest rate of qualified shareholder's (or related party's)

to the value of the company's own shares held as treasury stock must be registered on the liability side of the balance sheet and kept until the shares are disposed of or canceled.

³⁰Circular 11/E illustrates the rule by this example. A company had an operating loss of 5,000x in 2001 and profits of 3,000x in 2002 and 2003. To determine the nondeductible interest in 2004, reference has to be made to the company's net equity for 2003. The 2001 loss is covered by accumulated profits for a total amount of 4,000x. The balance of the loss, equal to 1,000x, shall not reduce the company's net equity provided that the shareholders make an additional contribution to capital within the approval of the financial statement for the year 2003. Assuming that the financial statement is approved by June 30 each year, the contribution shall have to be made by June 30, 2004. Otherwise, the net equity at the denominator of the fraction (both for the general and specific debt-to-equity ratio) shall be reduced by 1,000x uncovered loss.

³¹Controlled companies are companies under control within the meaning of Civil Code section 2359. Related companies are companies in which another company can exercise a significant influence, whether through stock ownership or otherwise. That provision is aimed at avoiding the possibility that the equity contributed by the shareholder is contributed to controlled companies to artificially increase the equity of those companies, thereby reducing the debt-to-equity ratio that helps avoid the application of the rules. However, it also applies when the shares have been purchased from third parties.

interest-bearing loans exceeds the official reference rate (at the time of this writing, 2 percent) plus 1 percent. Therefore, if the average disqualified debt for a qualified shareholder is 11,000x and the shareholder's net equity is 2,000x, considering the permitted debt-to-equity ratio of 4 to 1, the permitted debt would be 8,000x and the excess debt would amount to 3,000x.

2. Average Interest Rate

The average interest rate is equal to the total remuneration paid or accrued on all disqualified debt divided by the total average amount of disqualified debt for the tax year.³² Therefore, if the total remuneration paid or accrued on disqualified debt is 360x and the average amount of disqualified debt is 11,000x, the average interest rate would be 3.27 percent. By applying the average interest rate to the qualified shareholder's excess debt, the amount of nondeductible interest is obtained.

3. Nondeductible Interest

Nondeductible interest is equal to the product of the average interest rate and the qualified shareholder's (or related party's) excess debt. In the above example, the nondeductible interest portion amounts to 98.1x (3,000x X 3.27 percent), while the deductible interest portion amounts to 261.9 (360 - 98.1). Nondeductible interest is recaptured by an upward adjustment to the book income on the basis on which taxable income is computed.

F. Recharacterization of Nondeductible Interest as Dividends

Tax Code section 44(1)(e) provides that dividend income includes interest nondeductible under the thin capitalization rules of tax code section 98, paid or accrued on debt directly held by a qualified shareholder (or its related parties). A similar provision is contained in Tax Code section 89(2) that applies to dividend income of corporate taxpayers.

The recharacterization of interest nondeductible under the thin capitalization rules as dividend applies only to interest paid or accrued to a qualified shareholder or its related parties on credit that they directly extended to a related borrower. Nondeductible interest paid or accrued on debt held by a third-party lender (for example, a bank) and guaranteed by a qualified shareholder (or its related parties) is not recharacterized as dividend. The recharacterization applies to interest paid or accrued to both domestic and foreign lenders.³³

³²Tax Code section 98(3)(g).

³³The technical explanation of Legislative Decree 344 of 2003, which enacted the corporate tax reforms that include the thin capitalization rules, in one passage states without
(Footnote continued on next page.)

In a domestic context, the recharacterization of interest as dividend is favorable to taxpayers and is aimed at avoiding double taxation of the same income as a result of the nondeductibility of interest on part of the related lender. Indeed, dividends are exempt from tax for 95 percent of their amount if paid to corporate taxpayers (which is equivalent to an effective tax rate of 1.65 percent) and for 60 percent of their amount if paid to individual taxpayers on qualified shares or in connection with the carrying on of a trade or business (which is equivalent to a maximum effective rate of about 16 percent).³⁴ Interest is taxable in full at the ordinary corporate or individual tax rates. In a cross-border context, the analysis is quite different. Although taxation of outbound interest differs greatly depending on the nature of the debt on which interest is paid, it is fair to say that the effect of the recharacterization is generally unfavorable to taxpayers. Outbound dividends are subject to withholding tax at the rate of 27 percent.³⁵ No statutory exemptions from withholding tax are allowed under domestic tax law, except for dividends paid to an EU parent, which are exempted from the withholding tax under the 1990 EC parent-subsidiary directive if all requirements are met.³⁶ The withholding tax on dividends is usually reduced under tax treaties, but never to zero and usually to a lesser extent than the treaty reduction of domestic withholding tax on interest. Interest on debt obligation is subject to withholding tax at the statutory rate of 12.5 percent (instead of the 27 percent withholding tax on dividends) and is often eliminated by tax treaties or reduced to a greater extent than the treaty reduction of withholding tax on dividends. In addition, the recharacterization applies only for Italian tax law purposes and not for foreign law purposes. If for foreign law purposes the payment is still characterized as interest, the final result might be nondeductibility of the interest from the payer's taxable income in Italy, application of a higher Italian withholding tax on the outbound deemed dividend,

further elaboration that the recharacterization of nondeductible interest as dividends applies only to interest paid or accrued to resident lenders. Because Tax Code section 44(1)(e) applies equally to interest paid or accrued to resident as well as nonresident lenders, that statement in the technical report is wrong and probably due to an oversight.

³⁴Under the new participation exemption rules of Tax Code sections 89 and 59, which replaced the imputation credit.

³⁵Article 27(3) of Presidential Decree 600 of Sept. 29, 1973. That withholding tax can be reduced up to four-ninths of its amount (that is, down to a minimum 15 percent), to the extent of any foreign taxes paid by the recipient on that dividend of which the recipient must provide sufficient proof.

³⁶Article 27-bis of Legislative Decree 600 of Sept. 29, 1973.

and inclusion in the payee's foreign country taxable income (as interest). The end result is almost the equivalent of triple taxation.

The recharacterization of interest as dividends also raises a number of technical tax issues. The first issue is a timing issue. Because the amount of outstanding debt and the status of a qualified shareholder (or related party) relevant to the application of the thin capitalization rules exist in and must be checked with reference to the current tax year, it is generally not possible to determine whether the thin capitalization rules apply and any related-party interest is nondeductible and recharacterized as dividend until the end of the current tax year. The solution adopted by Circular 11/E³⁷ is that interest paid during the current tax year is subject to the withholding tax according to the ordinary rules³⁸ on interest. The withholding tax may be reduced under the interest provision of any applicable tax treaty. If at the end of the current tax year it is determined that the payment received during the year is nondeductible and recharacterized as dividend under the thin capitalization rules, then the rules on taxation of dividends retrospectively apply. That means that resident recipients must make a downward adjustment of their taxable income for the year in an amount equal to the amount of the interest. They must report 40 percent of the amount of the deemed dividend payment, if individual shareholders or partnerships that hold qualified shares of stock of the payer, or 5 percent of the amount of the deemed dividend payment, if corporate shareholders, as taxable income in their tax return for that year. The withholding tax charged at the time of the payment is given as a credit and offsets the tax owed on their taxable income for the year that includes the deemed dividend payment reported as described above.³⁹ Nonresident taxpayers do not file a tax return in Italy, and the withholding tax on outbound

³⁷Which confirms on that point the conclusion reached by the tax administration in Circular 26/E issued on June 16, 2004 (and containing guidance on the rules on taxation of dividends and participation exemption).

³⁸Article 26(5) of Presidential Decree 600 of Sept. 29, 1973, which provides for a 12.5 percent withholding tax, increased to 27 percent on interest paid or accrued to a recipient who is resident in a tax haven jurisdiction.

³⁹To determine whether the shares are qualified shares for the exemption of 60 percent of the deemed dividend paid to a qualified shareholder (or its related party) that is an individual or a partnership, reference is made only to the stock owned directly by that shareholder or its related party with no stock attribution. If the shares are not qualified shares, the payment is subject to a final withholding tax at the rate of 12.5 percent and the previous withholding tax is granted as a credit and offsets the tax owed on the shareholder's unrelated taxable income for the year. If no tax is due, it can be claimed as a refund.

interest payment is a final tax. Therefore, for those subject to the 27 percent withholding tax on outbound dividends, the Italian payer must remit the balance of withholding tax⁴⁰ due on its behalf out of its own funds. If the nonresident taxpayer is an EU parent company exempted from withholding tax under the EC parent-subsidiary directive, the initial 12.5 percent withholding tax can be claimed as a refund. The same rules should apply if the withholding tax on the deemed dividend is reduced under a treaty below the initial 12.5 percent interest withholding tax. If the deemed dividend is paid in a subsequent tax year, the dividend withholding tax applies directly.

For the general exception, the borrower's credit capacity must be assessed on the basis of the borrower's net equity.

A different timing issue arises when the payer and payee are resident corporations with a different tax year and payment is made in a tax year following the year of accrual. Then the interest is included in income in the year of accrual for its full amount. In a normal situation, it would not be reported as income a second time when paid. However, if the interest were recharacterized as a dividend, technically it would need to be reported as income also at the time of payment. The solution envisaged by Circular 11/E to avoid any possible double taxation is that the payee should make a downward adjustment of its taxable income for the year of accrual (by filing an amended tax return) by an amount equal to the amount of interest accrued at that time, and an upward adjustment of its tax year for the year of payment for an amount equal to the taxable portion of the deemed dividend received.⁴¹

If the borrower is a partnership or a corporation taxed as a partnership under the "check-the-box" rules, the provision on recharacterization of interest as dividend does not apply. In that case, the nondeductible interest generates additional income at the level of the borrowing partnership, which must be allocated to the qualified shareholder-partner lender for its entire amount.⁴²

If disqualified debt is held by two or more qualified shareholders and/or related parties, the share of

the total amount of nondeductible interest recharacterized as a dividend must also be allocated to each of them. For that purpose, the computation is made in proportion to their relative percentage shares of interest accruing on the disqualified debt. Circular 11/E illustrates that rule with the following example. Shareholder A holds 2,000x of disqualified debt on which interest accrues at the rate of 5 percent, for a total amount of 100x per year. Shareholder B holds 4,000x of disqualified debt on which interest accrues at a rate of 8 percent, for a total amount of 320x per year. Total disqualified debt is 420x. Computation of A's and B's shares of nondeductible interest must be made in proportion to their respective share of total interest accruing on disqualified debt. A's share of total interest accruing on disqualified debt is $(100 \div 420 =)$ 23.80 percent. B's share of total interest accruing on disqualified debt is $(320 \div 420 =)$ 76 percent. Therefore, assuming that the total amount of nondeductible interest is 350x, A's share of nondeductible interest recharacterized as a dividend is equal to $(350 \times 23.80 \text{ percent} =)$ 83.30x and B's share of nondeductible interest recharacterized as a dividend is equal to $(350 \times 76.50 \text{ percent} =)$ 266.70.

G. The General Exception

The thin capitalization rules do not apply if the borrower furnishes sufficient evidence that the disqualified debt is justified by its own borrowing capacity assessed on the basis of its net equity and that it would have obtained the same credit from independent third parties acting at arm's length.⁴³ In that case, the interest on disqualified debt is treated according to the ordinary rules and is fully deductible (unless other earnings-stripping provisions apply).

For the general exception to the application of the rules, the borrower's credit capacity must be assessed on the basis of the borrower's net equity. It must demonstrate that similar credit would be extended by third parties relying solely on the borrower's net equity as a guaranty of repayment of the debt. Net equity for those purposes means the fair market value of borrower's net assets and potential future assets and liabilities connected with the borrower's activities carried out and risks undertaken in connection with the conduct of its trade or business. The test is very strict, requires a fair and thorough assessment of the borrower's current and potential net assets related to its trade or business that are to be valued in fair market value terms, and generic letters from banks or financing institutions and expert surveys are not per se sufficient to satisfy it. As it is phrased in the statute and illustrated in

⁴⁰12.5 percent, equal to the difference between the statutory withholding tax on interest (see note 38) and the statutory withholding tax on dividends (see note 35).

⁴¹Circular 11/E, paragraph 6, fifth and sixth sentences.

⁴²Circular 11/E, paragraph 6, 8th, 9th, 10th, and 11th sentences.

⁴³Tax Code section 98(2)(b).

the administrative guidance, that test seems to require a great deal of investigation and effort on the part of the taxpayer and would be very difficult to apply.

However, the tax administration in Circular 11/E significantly relaxed it, opening a potentially great loophole in the application of the rules. The tax administration took the position that if related-party debt is raised through the issuance of debt obligations, then the test can be deemed to have been satisfied and the exception applies. In other terms, according to the tax administration, the use of debt obligations to raise debt financing would amount to a (irrefutable) presumption that the debt is justified on the basis of the borrower's own credit capacity and automatically triggers the exception to the application of the thin capitalization rules. That is equivalent to saying that interest on debt obligations held or guaranteed by related persons does not fall within the scope of the thin capitalization rules. To explain that position, the tax administration pointed to the provisions of the Civil Code that put specific limits on a company's ability to issue debt obligations. It assumed that those limits by themselves are sufficient to ensure that the requirements for the application of the thin capitalization rules are met and the test for the general exception to the rules is automatically satisfied.

However, a brief analysis of the provisions of the Civil Code referred to by the tax administration reveals that its assumption is wrong.

As a general rule,⁴⁴ an SPA is allowed to issue debt obligations for a total value not in excess of 200 percent of its total net equity (paid-in capital, plus legal reserve and capital, and profit reserves) as it appears from the latest approved company's financial statement. Therefore, company law would seem to require a debt-to-equity ratio of 2 to 1 for debt raised through the issuance of debt obligations. Moreover, an SPA is not authorized to distribute its reserves or reduce its capital to a value that is below 200 percent of the face value of the company's outstanding debt obligations. Therefore, it appears that the ratio would have to be maintained throughout the operation of the company. For losses that reduce a company's reserves or require a mandatory reduction of a company's capital, no profits can be distributed until and unless the amount of capital and reserves is at least equal to the face value of the company's outstanding debt obligations. An SRL is not allowed to issue debt obligations. It can issue debt instruments, but only to institutional investors

⁴⁴See Italian Civil Code article 2413, which applies to SPAs.

(banks).⁴⁵ All of those limitations and qualifications do not seem to be sufficient to automatically trigger a limitation to the application of the thin capitalization rules under the borrower's own credit capacity exception. Indeed, that exception as set forth in the statute requires a fair assessment of the borrower's credit capacity as a whole, based on its total net equity weighed against the backdrop of the borrower's overall debt, whether represented by debt obligations or other financing arrangements and held by related persons or third parties. The idea of viewing the debt raised through debt obligations in isolation and as justified in itself is clearly questionable and has no grounds at all in the statute.

Italy's thin capitalization rules are complex and potentially dangerous for ill-advised taxpayers.

That opinion is even reinforced when looking to company law's exceptions to the limitations of a company's ability to issue debt obligations. Under those exceptions, SPAs can issue debt obligations without any limitations in three situations:

- if the obligations are initially purchased by institutional investors;⁴⁶
- if the obligations are secured by a first degree mortgage on real estate property owned by the borrowing company, for an amount not exceeding two-thirds of the fair market value of the mortgaged property; and
- if the borrower is a publicly traded company and the obligations are traded in a securities market.

The tax administration in Circular 11/E confirmed that also in those cases the thin capitalization rules do not apply because the above-mentioned provisions would already grant a fair balance between debt and equity and adequately protect investors. That conclusion is also very questionable and appears to reveal that the tax administration has lost its focus. It slipped over from the borrower's own credit capacity as exception to the thin capitalization rules (that clearly needs to be tested against the borrower's overall debt and net equity) to the protection of investors in the securities market, which has nothing to do with the thin capitalization rules' ratio and underlying policy.

⁴⁵See Italian Civil Code article 2483, which applies to SRLs.

⁴⁶*I.e.*, banks and other financial institutions. If subsequently transferred to noninstitutional investors, the transfer is valid but the transferor is jointly liable for the due repayment of the debt.

II. Other Antistripping Provisions

A. Transfer Pricing

Under the provisions of Tax Code section 110(7) and (8), interest charged by a foreign lender to a commonly controlled resident borrower must be at arm's length. The portion of interest that exceeds the arm's-length remuneration of the loan would be recharacterized as dividend and be nondeductible by the related resident borrower. Circular 11/E clarifies that the arm's-length principle takes precedence over the thin capitalization rule and applies on an independent basis.

B. Debt-Equity Characterization Rules

Tax Code section 44(2)(a) provides that financial instruments whose remuneration consists entirely in a participation in the economic profits of the borrower or a company of the same group or of the transaction in which they were issued shall be characterized as equity for all income tax purposes. That means that interest paid or accrued under those instruments is characterized as dividends and is nondeductible by the issuer. Recharacterization depends exclusively on the direct connection between the remuneration paid or accrued under the instrument and the profits of the issuer (or of a related person), and any other factor (repayment date, subordination, lender's rights to enforce payment, and so on) is not relevant. Under Tax Code section 44(2)(a), if even a minuscule portion of the remuneration does not consist in a participation to the profits of the issuer, the instrument is qualified as debt. However, the portion of the interest or other remuneration paid thereunder that directly or indirectly represents a participation in the economic profits of the issuer or other company of the same group or the transaction in which the instrument was issued would be nondeductible by the issuer under Tax Code section 109(9).⁴⁷ Circular 11/E does not provide clarification to the above provisions. However, it would also seem that those rules, based on the terms of the debt and not on the quality of the parties, take precedence over the thin capitalization rules and apply on an independent basis.

C. The Excess Interest Nondeductibility Rule

Article 3(115) of Law 549 of December 28, 1995, provides that interest paid or accrued on debt obligations issued by private companies at a rate that exceeds 200 percent of the official reference rate for publicly traded obligations and 166 percent of the official reference rate or nonpublicly traded obligations is nondeductible by the issuer. The official

⁴⁷Both Tax Code section 44(2)(a) and section 109(9) were enacted as part of the tax reforms of 2003.

reference rate set at this writing by the European Central Bank is 2 percent. Circular 11/E clarifies that the thin capitalization rules apply only to the portion of interest that remains after computation of nondeductible interest disallowed under article 3(115) of Law 549/1995.

D. The Financial Pro Rata Rule

Tax Code section 97 provides that if a company owns shares that qualify for tax exemption under the participation exemption regime⁴⁸ and the book value of the shares exceeds the book value of the company's net assets at the end of a tax year, a portion of the company's total interest expenses net of any nondeductible interest disallowed under the thin capitalization rule of Tax Code section 98, equal to the ratio of the excess value of the shares over the difference between the borrower's gross assets and adjusted net equity plus trade and service accounts payable, is nondeductible for tax purposes.⁴⁹ The rationale of the provision is to deny tax deductibility of interest apportioned to debt incurred for the purpose of purchasing tax-exempt shares for an amount determined under the formula established thereunder. The financial pro rata rule of Tax Code section 97 applies after the application of the thin capitalization rules and only to interest that is not already disallowed under Tax Code section 98.

E. The General Pro Rata Tax Rule

Under the general pro rata rule of Tax Code section 96, interest expenses that remain after the application of sections 98 (thin capitalization rules) and 97 (financial pro rata rule) are deductible only in the same proportion as total taxable income over total gross income of the borrower. Also, that rule applies after the application of the thin capitalization rules, as expressly provided for therein.

F. The Special Tax on Remuneration of Collateral Deposits

Article 7(1)-(4) of Law Decree 323 of June 1996 converted into law by Law 425 of August 8, 1996, provides that a special 20 percent flat rate tax applies to any remuneration paid on deposits of cash or securities other than stock made as collateral for loans granted to resident companies. The tax is generally collected through withholding from the

⁴⁸According to which 95 percent of the dividend is exempt from tax (Tax Code section 89) and the entire amount of gain from the sale or exchange of stock is tax-exempt if some requirements are met (Tax Code section 87).

⁴⁹Tax Code section 97 contains detailed provisions on computation of the numerator and denominator of the formula used for determining the portion of interest nondeductible thereunder, the illustration of which goes beyond the scope of this article.

remuneration and remitted by the resident lender who extended the credit to the resident borrower and with whom the collateral deposit has been made. That rule is essentially an anticonduit rule aimed at targeting schemes by which a credit to a resident company is extended by a nonresident bank through an interposed resident bank, thereby avoiding the withholding tax.⁵⁰ For collateral deposits made on debt held or guaranteed by a qualified shareholder or related party of the resident borrower, the special tax applies only to a portion of the remuneration paid under the deposit equal to the ratio of the nonexcess debt over the total disqualified debt. Therefore, in the example used in Circular 11/E to illustrate that coordination rule, if the amount of total disqualified debt is 100x, out of which 70x is nonexcess debt and 30x is excess debt, and a remuneration of 20x is paid on a deposit made as collateral for such debt, the special tax applies only to 14x; that is, the portion of the remuneration that bears the same ratio to the total remuneration that the nonexcess debt (70) bears over the total disqualified debt (100) equal to 70 percent.

III. Conclusion

Italy's thin capitalization rules are complex and potentially dangerous for ill-advised taxpayers.

⁵⁰The scheme usually implies that a nonresident bank makes a deposit of cash or securities with a resident bank as collateral for an extension of credit to be made by the resident bank to a resident borrowing company. The resident bank uses the money or securities deposited as collateral to extend the credit. The nonresident bank personally guarantees the repayment of the debt to the resident bank, which is therefore insulated from any financial risks in the transaction. Payments from the resident bank-lender to the nonresident bank-guarantor under the deposit are exempted from withholding tax as interbanking interest under a statutory exclusion.

Most of the tests that determine the application of the rules are factual nonmechanical tests that are difficult to administer and to apply by taxpayers. They trigger the most unfavorable tax consequences when applied in a cross-border context to interest paid or accrued in favor of a foreign lender (except for EU parent companies exempted from dividend withholding tax under the EC parent-subsidiary rule), potentially leading to triple taxation of profits purposefully stripped out from Italy as deductible interest. Nonresident companies engaged in acquisitions of Italian companies through highly leveraged private companies established in Italy as special purpose vehicles to properly consummate the acquisition in an efficient manner from a tax standpoint⁵¹ must pay specific attention to those rules. Moreover, the thin capitalization rules apply together with both general and more transaction-specific antistripping provisions, the coordination with which requires additional study and proper tax planning by taxpayers. ♦

⁵¹There are several tax-related reasons to establish an Italian acquisition vehicle to acquire an Italian company. Among them, the desire to optimize the use of third-party or internal acquisition debt by combining interest costs on acquisition debt with postacquisition or merger profits of the Italian target or merger party, the desire to facilitate consolidation, and the desire to facilitate a repatriation of the investment free from withholding tax. A discussion of that topic goes beyond the scope of this article. For a general analysis of the matter, see Nathan Boidman et al., "Role of a Target Country Acquisition Corporation (Special Purpose Vehicle)," *Tax Notes Int'l*, Feb. 21, 2005, p. 663.