taxanalysts
Respectfully disagreeable since 1970.

tax notes international

VOLUME 49, NUMBER 4 ■ JANUARY 28, 2008

Italy Introduces Broad Corporate Tax Reforms

by Marco Rossi

Reprinted from *Tax Notes Int'l*, January 28, 2008, p. 307

taxanalysts tax notes international

Italy Introduces Broad Corporate Tax Reforms

by Marco Rossi

Italy's Budget Law for 2008 (no. 244 of December 24, 2007) contains significant corporate income tax (IRES) reforms. The new tax measures generally take effect for tax years beginning on or after January 1, 2008. (For prior coverage of the Budget Law for 2008, see *Tax Notes Int'l*, Jan. 7, 2008, p. 40, *Doc 2007-28090*, or *2007 WTD 248-1*.) The main corporate tax reforms enacted as part of the 2008 Budget Law include:

- reductions of corporate income tax and regional tax rates;
- improvements to the participation exemption rules;
- a reduction of the statutory withholding tax on outbound dividends in the European Union;
- a stepped-up basis in tax-free reorganizations;
- the repeal of thin capitalization rules and the introduction of a new limitation on the deduction of interest;
- the elimination of some benefits in the tax consolidation regime;
- the deferral of some deductions and an increase of the tax base;
- a new white list for cross-border transactions;
- clarifications of the rules on publicly traded real estate investment companies;
- an extension of the deadline for the liquidation of nonoperating companies at the reduced tax rate; and
- new rules on the deduction of interest on acquisition financing for real estate companies.

Reduction of Tax Rates

Italy is following a European trend of reducing nominal corporate tax rates. The corporate tax rate has been reduced from 33 percent to 27.5 percent, and the regional tax rate has been reduced from 4.25 percent to 3.9 percent. The new combined tax rate on corporate profits is 31.5 percent.

Participation Exemption Rules

Italy's participation exemption rules exempt from tax dividends and capital gains from sales of stock or other equity interests in noncorporate entities. The participation exemption rules, enacted in 2004, replaced the imputation credit and seek to eliminate or reduce the double taxation of corporate profits.

No specific requirements (that is, no minimum holding period or stock ownership) apply for the exemption of dividends. The only limitation is that dividends paid by foreign entities resident in some low-tax jurisdictions included in a specific blacklist approved by the Ministry of Finance are fully taxable. A look-through rule applies to disqualify dividends distributed by upper-tier nonblacklisted companies out of earnings and profits represented by dividends the companies received from lower-tier blacklisted subsidiaries.

Dividends received by individuals regarding qualified (nonportfolio) stock (that is, stock that carries voting power and profit shares that exceed specific thresholds) or stock held in connection with a trade or business or by partnerships and other passthrough entities are 60 percent exempt and 40 percent taxable, at graduated rates. Dividends received by corporate shareholders are 95 percent exempt and 5 percent taxable (at the corporate rate).

Four requirements must be met to qualify for the exemption of gains:

- the stock must be held without interruption for a minimum period (holding period);
- the stock must be booked as a long-term asset on the shareholder's financial statement (booking requirement);
- the company whose stock is sold must be engaged in the active conduct of a trade or business (active business requirement); and
- if the company is organized in a foreign country, it must not be resident in a low-tax jurisdiction included in the blacklist.

When originally enacted, the minimum holding period requirement was 12 months.[1] Later it was increased to 18 months, but the minimum holding period for the disallowance of a loss from a sale of stock was maintained at 12 months. As a result, for stock sold after 12 months but less than 18 months from the date of purchase, any gain would have been taxable, but any loss would have been nondeductible. The 2008 Budget Law reduced the holding period for the exemption of gains back to 12 months, thereby eliminating the risk of a different treatment of gains and losses based on a different holding period, which was seen as inappropriate.

The new rules clarify that the exemption applies if the stock is held as an investment asset and that the only exception is stock held as inventory by dealers in stock and securities.

When it was originally enacted, the requirement for the exempt portion of gains for corporate shareholders was 95 percent (the same as for dividends). Later it was reduced to 91 percent, and then to 84 percent. The new rules have increased the exempt gain back to 95 percent. The effective tax rate on stock gains is now 1.375 percent.

As provided under prior law, the exemption of dividends and gains applies to stock and other financial instruments or arrangements that are characterized as stock for tax purposes under the recharacterization rules of section 44, paragraph 2(a) of the tax code. Under the recharacterization rules, a financial instrument or arrangement is characterized as stock for income tax purposes if remuneration to the holder of the instrument consists entirely of a participation in the profits of the issuer, an affiliated company of the issuer, or the transaction for which the instrument has been issued. Stocks and other financial instruments issued by a foreign issuer are eligible for the participation exemption if the remuneration to the holder of the instrument is totally nondeductible by the issuer under foreign law.

The exemption also applies to equity interests in unincorporated domestic and foreign entities (if the nondeductibility requirement under foreign law is satisfied).

Foreign corporations and other entities are eligible for the 95 percent exemption of dividends and gains from the sale of stock of Italian companies that they own through an Italian permanent establishment. The Italian PE is treated in the same way as a domestic company under the participation exemption rules.

[1]The statute required that the stock be held consecutively from the first day of the 12th month preceding the sale. Therefore, the holding period technically could be longer than 12 months.

Stock is treated as being owned through a PE if it is effectively connected to the PE's trade or business or is carried on the PE's books.

For Italian stock owned directly (rather than through an Italian PE), foreign corporate shareholders are entitled to a 60 percent exemption of gain, with the remaining 40 percent taxed at the corporate rate, which is equivalent to an effective tax rate of 11 percent. Gains from sales of publicly traded portfolio stock are treated as foreign-source income and are excluded from tax. For treaty partners that qualify for treaty benefits, stock gains may be exempt under tax treaties.

Stock of real estate investment companies is not eligible for the exemption. However, the exemption is allowable if the real estate company is engaged in an active real estate business (for example, the management or operation of commercial property or shopping malls, the rental of office or commercial spaces, and the provision of managerial and other services to tenants for a fee).

Outbound Dividend Withholding Tax

Italy's statutory rate of withholding tax on Italian-source dividends paid to foreign shareholders is 27 percent. Foreign shareholders are entitled to a refund of up to four-ninths of the withholding tax for any taxes paid on the dividends in their home country. Dividends paid with respect to saving shares (a particular class of nonvoting shares) are subject to a 12.5 percent withholding tax.

Under the new law, dividends paid to companies that are resident in an EU member state (under their own country's law) or in a state that belongs to the European Economic Area and that are included in the white list of jurisdictions are subject to withholding tax at the reduced rate of 1.375 percent. The reduced rate is equivalent to the corporate tax rate (27.5 percent) multiplied by the taxable amount of the dividend paid to a domestic corporate shareholder (5 percent). Therefore, the new reduced withholding rate equalizes the tax treatment of corporate shareholders' domestic and outbound dividends within the European Union.

The reduced withholding rate brings the Italian law on taxation of dividends into compliance with the EC Treaty, which prohibits member states from discriminating against foreign investors, in violation of the principle of freedom of establishment, by subjecting outbound dividends paid to EU corporate shareholders to a higher tax than that which applies to dividends paid to domestic shareholders.

The European Court of Justice ruled on this issue in *Denkavit* (C-170/05) at the end of 2006 (see *Doc 2006-24958* or *2006 WTD 241-13*). In that case, France subjected dividends paid by two French subsidiaries to their Dutch common parent to a 25 percent withholding tax, reduced to 5 percent under the Netherlands-France income tax treaty (the EU parent-subsidiary directive had not been enacted at that time). Dividends paid to a domestic parent would not have been subject to withholding tax and would have been exempt (up to 95 percent of the amount) in the hands of the recipient. The ECJ held that by subjecting outbound dividends to a higher tax than domestic dividends, the French law violated the EC Treaty and unlawfully restricted the parent company's freedom of establishment in France.

The ECJ recently affirmed that ruling in *Amurta* (C-379/05), which concerned dividends paid by a Dutch company to a Portuguese company regarding portfolio stock. (For the ECJ judgment in *Amurta*, see *Doc 2007-24955* or *2007 WTD 218-13*.)

The Italian reduced withholding tax rate on EU dividends applies both to portfolio and intercompany stock. Of course, tax treaties and the EU parent-subsidiary directive still apply. Therefore, if the EU parent is entitled to the benefits of the EU parent-subsidiary directive, the withholding tax is eliminated.

Tax Basis Step-Up

Under current law, the contribution of a business or a line of business as a going concern solely in exchange for the stock of the transferee corporation and the transfer of assets in a merger or spinoff in which the shareholders of the target corporation exchange their stock (in the target) for stock of the acquiring corporation are nonrecognition transactions. The transferee or acquiring corporation takes a carryover basis in the transferred assets, and the transferor or target's shareholders take a substituted basis in the transferee's or acquiring corporation's stock received in the exchange.

The new rules provide that the acquirer or transferee can elect to step up the tax basis of the acquired or retained assets to fair market value to benefit from higher depreciation deductions or reduce any future taxable gain from the sale of any of the assets. The stepped-up basis is subject to a substituted tax on the difference between the historic tax basis and the new fair market value basis (the deemed gain). The tax rates are 12 percent on the first €5 million, 14 percent on the portion between €5 million and €10 million, and 16 percent on the amount exceeding €10 million of the deemed gain. The substituted tax applies in lieu of ordinary corporate tax and can be paid in three yearly installments (30 percent-40 percent-30 percent) with an interest charge of 2.5 percent.

The election and the obligation to pay the tax belong to the acquirer or transferee. It is not clear from the statute whether, in case of election, the transferor or target's shareholders take a step-up basis in the stock received in the transaction.

The acquirer or transferee can choose the assets to which the total amount of stepped-up basis should be apportioned to maximize the benefits of the basis step-up. The new stepped-up basis applies from the tax year in which the transaction has been carried out, for purposes of depreciation and amortization deductions, and from the fourth year after the tax year in which the transaction has been carried out for purposes of computing the gain from the sale of the assets that were stepped up. If an asset is sold before the end of the fourth year after the year of the transaction, the basis of the asset is reduced to its original tax base and the full gain is subject to corporate income tax reduced by the amount of the substituted tax paid.

The election for the stepped-up basis is available for transactions carried out after December 31, 2007, and to eliminate any tax/book differences existing on the balance sheet at the end of the tax year under way on December 31, 2007, or the immediately following tax year.

New Limitation on Interest Deduction

Under previous law, if the ratio of the borrower's debt held or guaranteed and the equity owned by a qualified shareholder or its related parties exceeded 4 to 1, the interest paid or accrued on the debt directly or indirectly held or guaranteed by a qualified shareholder or its related parties in excess of the permitted debt-to-equity ratio was nondeductible.

The debt-to-equity ratio was computed both at the aggregate level of all qualified shareholders and related parties and at the level of each single qualified shareholder and related parties to determine the applicability of the rules and to compute the amount of nondeductible interest.

Qualified shareholders were defined as shareholders that control the borrower or that own at least 25 percent of the borrower's stock. Related parties were defined as companies controlled by a qualified shareholder. The borrower could avoid application of the rules by proving that the financing was obtained through its own credit capacity, and not as a result of its relationship with the related-party lender or guarantor.

Also under previous law, interest was nondeductible to the extent that it was allocated to stock that qualifies for the participation exemption under the equity pro rata rule, or to the borrower's exempt income under the general pro rata rule.

The new rules repeal the thin capitalization, equity pro rata, and general pro rata rules and replace them with a new limitation on the deductibility of corporate interest.

Under the new rules, interest expense can be deducted up to the amount of interest income. Any excess of interest expense over interest income (net interest expense) is deductible up to 30 percent of the borrower's gross accounting profit or earnings before interest, taxes, depreciation, and amortization. The excess of net interest expense over that limitation amount (excess interest) can be carried over to, and deducted in, future years, up to the limitation amount available in those years.

Initially, the bill provided for a five-year carryover period, which was increased to 10 years for the excess interest accrued in the first three years of the application of the new rules. However, in its final version, the Budget Law allows for indefinite carryover. Similarly, beginning in the third year of application of the new rules, any excess of the limitation amount over the net interest expense of a tax year can be carried over to — and increase the limitation available in — future years.

Excess interest of a member of a tax-consolidated group can be transferred to another member of the group and deducted by the latter (up to the limitation amount available to it). Similarly, the excess limitation of a member of the group can be transferred to another member of the group and can increase the ability of the latter to deduct its own net interest expense. For that purpose, a tax group includes foreign affiliates that would qualify for consolidation under the domestic tax consolidation rules.

General partnerships and limited liability partnerships are not subject to the limitation on interest deduction. However, the ability to get around the limitation by moving the debt at the level of the partnership and passing the partnership's losses through to the corporate partners has been curtailed by the legislature, which enacted an antiabuse rule that establishes that a partner's share of the partnership's losses can be offset only against that partner's share of that partnership's income passed through in future years (up to five years).

Under the literal meaning of the statute, the antiabuse rule does not apply to LLCs that elect to be treated as partnerships under Italy's check-the-box rules. Banks, finance companies, and insurance companies are outside the scope of the new limitation on interest deduction.

Tax Consolidation

Tax consolidation rules took effect in Italy on January 1, 2004, as part of the general corporate tax reforms of 2003. Under the rules, each affiliated member of the tax group computes its own taxable income or loss and passes it on to the parent company. The parent company then combines each affiliate's and its own tax profits and losses and computes the total consolidated taxable income or loss of the group, and either pays the tax due or carries over or claims a refund for the excess taxes paid in advance during the tax year. Group affiliates' tax credits, withholding taxes, and preconsolidation excess taxes also are consolidated and used by the parent to offset the tax on the group's total taxable income.

The threshold for consolidation of domestic subsidiaries is ownership of more than 50 percent of the stock by value and profit share, and ownership of more than 50 percent of the voting power or sufficient votes (even if under 50 percent) to exercise a dominant influence on the affiliate. The threshold for consolidation of foreign subsidiaries is ownership of more than 50 percent of the stock by vote, value, and profit share. A separate set of rules applies to the worldwide consolidation of foreign affiliates.

Under previous law, in computing the taxable income of the group, the parent company made a downward adjustment for the taxable portion of intragroup dividends and gains from intragroup transfers of appreciated assets. As a result of the adjustment, intragroup dividends were totally nontaxable. For intragroup transfers of assets, the transferee member of the group would take a carryover basis in the transferred assets, and taxation of the gain would be deferred.

Under the new rules, intragroup dividends are partially taxable (5 percent) like dividends distributed outside a tax-consolidated group, and the transfer of appreciated assets is a taxable transaction unless it qualifies for nonrecognition treatment under rules unrelated to the tax consolidation regime.

Also, group members can realign (step up to fair market value) the tax basis of shares previously written down under the pre-2006 regime by paying a 6 percent substituted tax in lieu of corporate tax and regional tax.

Finally, in the case of termination of a worldwide consolidation, the tax losses of foreign affiliates deducted by the group are recaptured up to the amount of dividends paid by, or gains realized from, the sale of stock of those foreign affiliates after termination of the consolidation.

Off-Balance-Sheet Deductions

Under previous law, some costs (depreciation, writedowns and devaluations, and allowances) could be deducted for tax purposes even if they were not deducted for book purposes. Correspondingly, a reserve had to be booked on the liability side of the balance sheet and could not be distributed in excess of corresponding profits.

The opportunity for off-balance-sheet tax deductions is eliminated under the new rules. In general, tax deductions are allowed only for and up to the amount of items that are also accounted for and deducted for book purposes. As a result, there is now a strict link between taxable income and financial income. The treatment of losses and expenses for accounting purposes is subject to scrutiny to avoid abuses.

Tax deductions in excess of the book deduction under the previous rules can be recaptured, with realignment of the tax basis of the assets or items they refer to, through the payment of a substituted tax at the same rates of 12 percent, 14 percent, and 16 percent that apply to the basis step-up in tax-free reorganizations.

Also, reserves that are subject to clawback in the case of a distribution in excess of the corresponding profits can be freely distributed by paying a 1 percent substituted tax.

Depreciation Deductions

Generally, depreciation is deducted under a straight-line method on the basis of depreciation rates and schedules approved by the tax administration for different classes of assets.

Previous law allowed accelerated depreciation equal to two times the ordinary depreciation rates during the first three years after the purchase of new assets or during the first year after the purchase of used assets, and extraordinary depreciation based on a particularly intense use of the assets (determined on a case-by-case basis).

The new rules repeal both the accelerated and extraordinary depreciation.

Also, the minimum contractual duration of financial leases for the purpose of deducting the lease payments has been increased to two-thirds of the depreciation schedule for the leased assets (with a minimum of 11 years and a maximum of 18 years for immovable property).

Cross-Border Transactions

Under previous law, for the purposes of various antiabuse and antideferral provisions of the Italian tax code — including rules on controlled foreign companies, denial of deductions for costs incurred in transactions with foreign entities, full taxation of dividends and stock gains from foreign entities, increases in withholding tax on outbound interest payments, and the exemption of Italian-source portfolio income of foreign taxpayers — the tax administration adopted a list of low-tax jurisdictions (the blacklist) that triggered the application of the antiabuse provisions.

The 2008 Budget Law replaces the blacklist with a two-part white list of jurisdictions that are outside the scope of the aforementioned antiabuse provisions. The white list will be adopted through a decree to be issued by the Ministry of Economy and Finance in accordance with the criteria established in the new Budget Law.

For purposes of the rules on deductibility of costs incurred in transactions with foreign entities, withholding tax on outbound interest, the exemption of some items of Italian-source portfolio income of foreign investors, and the presumption of Italian tax residence for foreign holding companies, the new white list will be based solely on the fact that the foreign country operates an exchange of information system with Italy for income tax purposes, in accordance with an income tax treaty or other exchange of information agreement. As a result, the new list should be comprehensive.

For purposes of the rules on CFCs, full taxation of foreign dividends and gains, and general antiavoidance provisions, the new white list will be based on both the existence of an exchange of information system with, and the level of taxation existing in, the foreign country. The level of taxation should not be significantly lower than the Italian tax, but the statute does not prescribe any minimum threshold.

Publicly Traded REICs

The 2008 Budget Law also brought some clarifications and changes to the tax regime for real estate investment companies enacted as part of the Budget Law for 2007.

The new rules provide that the stock of a REIC can also be publicly traded in a stock market of an EU member state or a state of the EEA that qualifies under the new white list. The new rules do not address the problems of discrimination against foreign real estate investment funds, whose income is subject to higher tax in the hands of the Italian investors, and against foreign companies that would qualify as REICs if they were Italian resident companies, but are denied access to the new tax regime for their Italian-source real estate income.

Also, regarding the public trade requirement, at least 35 percent of a REIC's stock must be floating and owned by shareholders who individually own no more than 2 percent (as opposed to 1 percent) of the stock, by voting and profit share. That requirement is tested at the time of the election. Consequently, any postelection change in the amount of the floating stock or shares owned by individual shareholders will be irrelevant.

Finally, the withholding tax on dividends distributed by a REIC will be applied by the bank with which the REIC stock is deposited, instead of by the REIC itself.

Liquidation of Nonoperating Companies

Law Decree 223 of July 4, 2006, tightened the rules for nonoperating companies by reducing the minimum thresholds for applying nonoperating company status and increasing nonoperating companies' imputed taxable income.

The minimum thresholds, based on a company's ratio of assets to average gross revenue (measured with reference to the current and two preceding tax years), were fixed at less than 2 percent of the value of stock, less than 6 percent of the value of real estate, or less than 15 percent of the value of other assets (tangible or intangible) booked as fixed assets on the company's balance sheet (measured by book value).

The minimum imputed taxable income was fixed at 1.5 percent of the value of stock, 4.75 percent of the value of real estate, and 12 percent of the value of other assets carried as fixed assets on the company's balance sheet (measured by book value).

The 2007 Budget Law made some changes to those rules and made the nonoperating company regime subject to the regional production tax. The changes applied retroactively from July 4, 2006.

To counterbalance the tightening of the rules, the 2007 Budget Law introduced a favorable tax treatment for taxpayers that wanted to liquidate their nonoperating companies.

Eligible companies include nonoperating companies as of July 4, 2006, that do not meet the minimum revenue threshold but have income above the minimum imputed income, and whose shareholders are exclusively individuals. For that purpose, shareholders are those who are registered on the company's register of shareholders as of January 1, 2007, by virtue of a purchase carried out before November 1, 2006. If new individual shareholders join after January 1, 2007, the liquidation of the company is still possible, but the new shareholders are not eligible for the favorable tax treatment. Transfers of shares among existing shareholders do not affect the treatment of the liquidation.

The favorable tax treatment of the liquidation consists of reduced corporate income taxation and the elimination of shareholder-level tax. In particular, gains realized and income recognized in liquidation are taxed at a 25 percent flat rate in lieu of the ordinary corporate income tax and regional production tax that would otherwise apply (at a combined rate of 37.5 percent).

For computing the gain realized on the transfer of a company's assets in liquidation, the amount realized is deemed to be the higher of the fair market value of the assets and the consideration received (which is also the tax basis of the assets in the hands of the transferee).

For shareholders, the amount realized in the liquidation (equal to the money and fair market value of property received in liquidation) is reduced by an amount equal to the taxable income on which the substituted tax applied, less the amount of the substituted tax itself. As a result, an amount equal to the income recognized by the company and subject to the substituted tax is not taxed again in the hands of the shareholders. Any excess of the amount received by the shareholders in liquidation and their adjusted tax basis in the stock surrendered is taxed in the hands of the shareholders (as a dividend if out of the company's profits, or as a capital gain in all other cases) according to the general rules.

The transfer of assets to shareholders in liquidation is excluded from VAT.

The special tax treatment applies to liquidations resolved before May 30, 2007.

The 2008 Budget Law extended the liquidation of nonoperating companies to May 30, 2008, for calendar-year taxpayers. It also introduced additional exclusions to the application of the nonoperating companies' regime for companies with more than 50 shareholders, or gross receipts exceeding gross assets, or at least 10 employees on average during the two preceding tax years.

Deduction of Interest

Under previous law, real estate companies that owned real estate assets as investment assets and rental property were not entitled to deduct interest on financing obtained to purchase or renovate the property. They were taxed on gross rents reduced by 15 percent as a fixed allowance on account of costs, with all other costs in excess of the fixed allowance deemed nondeductible and disallowed.

A provision of the 2008 Budget Law clarifies that the costs and expenses deemed nondeductible do not include interest on loans obtained for the acquisition of the property. The new provision is labeled as a correction of the previous law and as such should apply retroactively and may lead to tax refunds. ◆

♦ *Marco Rossi is with Marco Q. Rossi & Associati in Genoa and New York.*