INTERNATIONAL BAR ASSOCIATION

RECENT DEVELOPMENTS IN INTERNATIONAL TAXATION

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ITALY

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1. SUMMARY

In recent years, Italy has swung between trying to make its tax system friendlier and more attractive for investors and embracing the OECD and EU campaigns to remodel international tax standards. However, the shaky situation of Italy's budget and public finances prevents more structural tax cuts that might have long-term positive ramifications. Moreover, the far-reaching interpretation of certain founding concepts of international tax law (e.g., corporate tax residence, permanent establishment, beneficial ownership) and a sometimes loose application of the Italian statutory general anti-abuse rule (GAAR) leave room for tax uncertainty in deal making and tax planning, which can be only partially relieved from the possibility of filing advance tax ruling applications to receive clearance from the tax authorities.

Italy has been a strong supporter of the G20/OECD's Base Erosion and Profit Shifting (BEPS) project and has recently changed its tax legislation to bring it in line with the outcome of the BEPS project and in particular with EU Directives 2016/1164 and 2017/952 (the Anti-Tax Avoidance Directives; "**ATAD**"). Italy signed the Multilateral Instrument to implement tax treaty related measures to prevent base erosion and profit shifting (MLI) on 7 June 2017. The MLI is however still in the process of being ratified. Italy listed 84 tax treaties as covered tax agreements, chose to apply the principal purpose test (PPT), instead of the limitation on benefits provision, to tackle treaty abuse, opted in for the arbitration procedure, and reserved entirely on many MLI provisions (e.g., the rules dealing with fiscally transparent entities, tie-breaker for dual-resident companies, commissionaire structures, splitting-up of contracts, dividend transfer transactions).

2. MAJOR TAX DEVELOPMENTS

The main amendments to the Italian tax legislation generally come every year-end when the Finance Act is approved and enacted. And 2019 is no different in this respect as Law No. 145 of 30 December 2018 ("**Finance Act 2019**") enacted some significant tax law changes. However, the most important changes to the Italian international tax landscape recently came from Legislative Decree No. 142 of 29 November 2018 ("**ATAD Decree**"), which implemented ATAD in Italy. Other important domestic tax law developments include: (i) the signing of the new double tax treaty with China in March 2019; (ii) the enactment of the digital services tax in Italy; (iii) the reopening of the temporary enhanced depreciation regime; (iv) the broadening of the domestic tax regime aimed at attracting non-resident employees and independent services providers to move their residence to Italy (so-called "*impatriati*"); and (v) new legal and tax rules targeted at fostering securitization transactions. Most of these developments were enacted by Law Decree No. 34 of 30 April 2019 ("**Growth Decree**").

2.1. Changes to the Italian interest barrier rule

The ATAD Decree significantly modifies the Italian interest barrier rule to make it consistent with ATAD. The most significant changes are as follows

- Under past rules, net interest expenses were deductible up to 30% of the accounting EBITDA. The accounting EBITDA is now replaced with an EBITDA based on the tax P&L (Tax EBITDA). The ATAD Decree provides for certain interim rules to handle the switch from accounting EBITDA to tax EBITDA;
- Until 2018, if 30% of the EBITDA of a tax year was greater than the amount of net interest expenses, the excess could be carried forward without any time limitation. The ATAD Decree sets a 5-year limitation to this carry forward. Any excess EBITDA still available at the end of tax year 2018 may be carried forward without any time limitation but only to deduct interest expenses accrued on financings entered into before 17 June 2016, provided that their maturity or amount has not been subsequently modified;
- The interest limitation rule is extended also to (a) interest capitalized in the cost of assets (including inventory), (b) interest accruing on trade payables, and (c) bond issuance costs that are deducted on a cash basis. All these expenses previously fell outside the scope of application of the interest barrier rule.

2.2. Changes to Italian CFC rules

The ATAD Decree reshapes and simplifies the Italian CFC rules. In particular:

- Scope of application: CFC rules will apply also to Italian permanent establishments (PE) of non-resident persons if the PE effectively holds controlling equity interests in foreign entities;
- Control: The notion of control is broadened. Under past rules, control was defined by reference to the legal concept of control under the Italian Civil Code. This requires that the Italian resident person be in a position to exercise a definite influence, via voting rights or even contractual relationships, over the decisions of the foreign entity. Under the new rules, an Italian resident person (or an Italian PE) will be deemed to control the foreign entity also if it holds, directly or indirectly, more than 50% of the profit participation rights in the foreign entity;
- CFC test: Under the new rules, a controlled foreign entity is a CFC if two conditions are met: (a) the foreign entity's effective tax rate is lower than 50% of the effective tax rate that would apply if that entity were a tax resident of Italy; and (b) more than one third of the revenues realized by the foreign entity are "tainted", i.e. interest, dividend, royalties, capital gains on shares and revenues from financial leasing; revenues from insurance, banking and other financial activities; revenues from trading goods that are purchased from or sold to associated enterprises, with the addition of no or little economic value; and revenues from supplying services that are purchased from or provided to associated enterprises, with the addition of no or little economic value. Whether the foreign entity sells goods or supplies services with little or no added value is determined based on transfer pricing regulations;
- Safe harbour: Even if the non-resident entity meets the CFC test, the CFC regime does not apply if the CFC carries on a substantive economic activity supported by staff, equipment, assets and premises.

If the two-pronged test is met and the safe harbour does not apply, the entire income of the CFC (and not just the tainted income) is attributed pro rata (based on profit participation) to the Italian controlling person. The CFC's income is computed based on Italian corporate tax rules and is ring-fenced from the other income of the Italian person and therefore taxed separately with no possibility to utilize tax losses other than those of the CFC.

2.3. Changes to the Tax Regime of Dividends and Capital Gains from Low-Tax Jurisdictions

Under domestic law, Italian resident enterprises (whether corporate or individual) may benefit from dividend and participation exemption regimes. However, these exemptions do not apply on foreign-sourced dividends and capital gains if the non-resident company that distributes the dividends (or that is sold) benefits from a low-tax regime. Italian resident individuals who do not hold the shares for the purpose of their business activity must fully include these "low-tax" dividends and capital gains in their tax base subject to progressive personal income tax rates (instead of taxing them by applying a 26% substitute tax). This full taxation regime has some exceptions.

The ATAD Decree changes the criteria to identify whether a foreign tax regime is "low-tax". In particular, two different criteria apply depending on whether the Italian shareholder controls the non-resident entity:

- Controlled entities: A foreign regime is deemed to be a low-tax regime if the foreign entity's effective tax rate is lower than 50% of the effective tax rate that would apply if that entity were a tax resident of Italy; and
- Other entities: A foreign regime is deemed to be a low-tax regime if the nominal foreign tax rate (as established by also taking into account special tax regimes) is lower than 50% of the nominal Italian tax rate.

The notion of control is the same as under CFC rules.

As under past law, tax regimes available in other EU or EEA States are not considered low-tax regimes for these purposes.

2.4. Anti-Hybrid Rules

The ATAD Decree implements the ATAD anti-hybrid provisions, with a wording that is, in many cases, almost identical to that of the Directive. However, there are some notable departures, such as, for instance, the notion of taxpayer, which is broader than in the ATAD and covers also business partnerships (fiscally transparent under Italian law) and individual entrepreneurs. The ATAD Decree also mandates special procedures for auditing and assessing hybrid mismatches.

The new anti-hybrid rules apply to fiscal years starting on or after 1 January 2020, except for the reverse-hybrids rules, which apply to fiscal years starting on or after 1 January 2022.

2.5. Repeal of Notional Interest Deduction Regime and New Reduced Tax Rate on Retained Earnings

Finance Act 2019 repealed the Italian notional interest deduction (ACE) regime that was in force since 2011. The ACE regime has been one of the most distinctive features of the Italian corporate tax system in the last years. Any excess of notional deduction still available on 31 December 2018 under the ACE regime can however be carried forward and be still used without time limitations.

In lieu of the ACE regime, the Growth Decree now provides for a reduced corporate tax rate applicable as of 2019 for companies that decide to retain earnings instead of distributing them. For calendar year companies, the reduced corporate tax rates are as follows: 22.5% for 2019, 21.5% for 2020, 21% for 2021 and 20.5% starting from 2022. The retained earnings benefitting from the reduced rate (i) do not include "non-disposable" reserves formed with profits that are booked in the P&L but not actually realized and (ii) may not exceed the accounting net equity increase calculated between 2018 and the relevant year for which the reduced rate should be applied, without considering the retained earnings that have already benefitted from the reduced rate in previous years (the "net equity increase cap").

The retained earnings exceeding the net equity increase cap may be carried forward to subsequent fiscal years for the purpose of applying the reduced tax rate. The benefit of the reduced rate may be transferred to the fiscal unit in the case of tax consolidation.

The new regime should not materially impact the taxation of banks and other financial intermediaries because the Growth Decree provides that the corporate surtax for banks (3.5%) will be adjusted upwards to make up for the reduced corporate tax rate.

2.6. Digital Services Tax

Finance Act 2019 enacted a new digital services tax (DST) that is substantially in line with the digital services tax proposed by the European Commission in March 2018.

Taxable persons are only those enterprises that (i) report worldwide revenues of at least EUR 750,000,000, whether on a stand-alone or consolidated basis, and (ii) realize revenues from digital services in Italy for at least EUR 5,500,000.

Revenues resulting from the provision of digital services to related entities are not subject to the DST.

The tax period is the calendar year. The taxable base of the DST is equal to the gross revenues (exclusive of VAT and other applicable indirect taxes) deriving from the supply of the digital services without taking into account any cost. Revenues obtained by an entity in a tax period are taxable in Italy if in that tax period the user of the digital service is deemed to be located in Italy under the sourcing rules set forth in Finance Act 2019.

The DST is levied at a 3% rate in each quarter and shall be paid within the end of the month following each quarter. Taxable enterprises must also file a DST return within the end of April. Non-resident companies that do not have a permanent establishment in Italy and are not registered for VAT purposes must request a DST identification number to the tax authorities if they fulfil the conditions to be subject to the DST in Italy.

The rules governing VAT apply for the assessment, penalties and collection procedures of the DST.

The Ministry of the Economy and Finance and the tax authorities should issue, respectively, a decree and a Commissioner's Regulation to set forth the implementing rules of the DST.

Based on the features of the DST and the legislative history of the EU Commission's proposal, there are strong arguments that could support the position that the DST is in fact a tax on income, which may therefore be generally covered by the OECD Model-based double tax treaties concluded by Italy.

3. CONCLUSIONS

Italy's tax system has undeniably improved in recent years, but Italy is still less competitive than other major countries (especially in the EU) from a tax standpoint. It is therefore key that Italy not lose momentum on tax matters because of the political stalemate in which the country is currently stuck.