

OVERVIEW OF ITALY'S CORPORATE TAX REFORMS ENACTED WITH THE BUDGET LAW FOR 2008

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INTRODUCTION

Italy's Budget Law for 2008 (n. 244 of December 24, 2007) contains significant changes in the area of Italian corporate income tax (IRES).

As a general proposition, the new tax measures take effect for tax years beginning on or after January 1, 2008. The main corporate tax reforms enacted with the 2008 Budget Law concern the following areas:

- Reduction of corporate income tax and regional tax rates;
- Improvement of participation exemption rules;
- Reduction of statutory withholding tax on outbound dividends in the EU;
- Stepped-up basis in tax free reorganizations;
- Repeal of thin capitalization rules and introduction of a new limitation on deduction of interest;
- Elimination of certain benefits on tax consolidation regime;
- Deferral of certain deduction and increase of the tax base;
- New "white list for cross-border transactions;
- Clarifications of the rules on publicly traded real estate investment companies (SIIQ);
- Extension of the deadline for the liquidation of non-operating companies at the reduced tax rate;
- New rules on deduction of interest on acquisition financing for real estate companies.

In this article we are going to analyze each part of the corporate tax reforms summarized above.

REDUCTION OF TAX RATES

The corporate tax rate is reduced from 33 to 27.5 percent. The regional tax rate is also reduced from 4.25 to 3.9 percent. The new combined tax rate on corporate profits is therefore 31.5 percent.

Italy is following a common trend in Europe towards a reduction of nominal corporate tax rates. A recent example, which Italy would seem to have taken into consideration, is Germany.

CHANGES TO THE PARTICIPATION EXEMPTION RULES

In 2004, Italy enacted its participation exemption rules, which exempt from tax dividends and capital gains from the sale of stock or other equity interests in non-corporate entities. The participation exemption rules replaced the imputation credit and are aimed at eliminating or reducing the double tax on corporate profits.

No specific requirements (namely, no minimum holding period or stock ownership) apply for the exemption of dividends. The only limitation provides that dividends coming from foreign entities that are resident in certain low-tax jurisdictions included in a specific list approved with a decree of the Ministry of Finance (so called “Black List”) are fully taxable. A look through rule applies to disqualify dividends distributed by upper tier non-black listed companies out of earnings and profits represented by dividends they received from lower tier black listed subsidiaries.

Dividends received by individuals with respect to qualified (non-portfolio) stock (that is, stock which carries voting power and profit shares exceeding certain thresholds), or stock held in connection with a trade or business, and by partnerships and other pass through 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 corporate rate).

For the exemption of gains, four requirements need to be met: the stock must be held without interruption for a minimum period of time (holding period) and must be booked as a long-term asset on shareholder’s financial statement (booking requirement); and the company whose stock is sold must be engaged in the active conduct of a trade or business (active business requirement) and (if it is organized in a foreign country) it must not be resident in a low tax jurisdiction included in the “black list”.

When enacted, the minimum holding period requirement was twelve months¹. Later on, it was increased to eighteen months. The minimum holding period for the disallowance of the loss from the sale of stock was maintained at twelve months. As a result, in case of stock sold after twelve months but prior to eighteen months from the purchase, any gain would have been taxable but loss would have been non-deductible. The 2008 Budget Law reduced the holding period for the exemption of gains back

¹ More precisely, the statute requires that the stock be held consecutively from the first day of the twelfth month preceding the sale. Therefore, the holding period technically can be longer than twelve months.

to twelve 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 make clear that the exemption applies if the stock is held as an investment asset, and the only exception is stock held as inventory by dealers in stock and securities.

When enacted, the exempt portion of gains for corporate shareholders was 95 percent (same as for the dividends). Later, it was reduced to 91 and then 84 percent. The new rules increased the exempt gain back to 95 percent. Therefore, 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 re-characterization rules of section 44, paragraph 2(a) of the tax code. Under the re-characterization rules, a financial instrument or arrangement is characterized as stock for income tax purposes if remuneration to the holder under the instrument consists entirely in a participation to the profits of the issuer, an affiliated company of the issuer, or the transaction with respect to which the instrument has been issued. Stock or other financial instruments issued by a foreign issuer are eligible for participation exemption if the remuneration to the holder under the instrument is totally nondeductible to the issuer under foreign law.

The exemption applies also to equity interests in unincorporated domestic and foreign entities (if the non deductibility 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 permanent establishment is treated in the same way as domestic companies for the purposes of the participation exemption rules. Stock is treated as owned through a permanent establishment if it is effectively connected to the permanent establishment's trade or business or is carried on the permanent establishment'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 while 40 percent of gain is taxed at corporate rate (which is equivalent to an effective rate of tax of 11 percent). Gains from sale of publicly traded portfolio stock are treated as foreign source income and 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 granted if the real estate company is engaged in an active real estate business (e.g., management or operation of commercial property or shopping malls, rental of office or commercial spaces and 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 4/9th of the withholding tax for any

taxes paid on the dividends in their own 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 a EU member state (under their own country's law) or in a state that belongs to the European Economic Area and is included in a specific list of jurisdictions (the "White List") 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) time the taxable amount of dividend paid to a domestic corporate shareholder (5 percent). Therefore, the new reduced withholding rate equates the tax treatment of corporate shareholders' domestic and outbound dividends within the EU.

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

The European Court of Justice (ECJ) ruled on this issue in its decision in *Denkavit*, issued at the end of 2006². Under the facts of 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 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, French law violated the EC treaty and unlawfully restricted the parent's freedom of establishment in France. Recently, the ECJ affirmed the above ruling with its decision in *Amurta*³, with concerns dividends paid by a Dutch company to a Portuguese company with respect to portfolio stock (14 percent by value).

The Italian reduced withholding tax rate on EU dividends applies both to portfolio and inter-company 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 altogether.

TAX BASIS STEP-UP IN NONRECOGNITION TRANSACTIONS

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

² ECJ ruling dated December 14, 2006 in case C-170/05.

³ ECJ ruling dated November 8, 2007 in case C-379/05.

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 such 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 (deemed gain). The tax rates are 12 percent on the first five million, 14 percent on the portion between 5 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 (30-40-30 percent) with an interest charge of 2.5%.

The election (and obligation to pay the tax) belongs 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 in order 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 the purposes of depreciation and amortization deductions, and from the fourth year after the tax year in which the transaction has been carried out, for the purposes of computing the gain from the sale of the assets that were stepped up. If an asset is sold prior to 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 12.31.2007 and to eliminate tax/book differences existing on the balance sheet at the end of the tax year under way on 12.31.2007 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 on nondeductible interest.

Qualified shareholders were defined as shareholders that control the borrower or own at least 25 percent of borrower's stock. Related parties were defined as companies controlled by a qualified shareholder. The borrower could avoid the 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 participation exemption under the equity pro rata rule, or to 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 totally new limitation on deductibility of corporate interest.

Under the new rules, interest expenses can be deducted to the extent of interest income. Any excess of interest expenses over interest income ("net interest expense") is deductible up to an amount not exceeding 30 percent of borrower's gross accounting profit or EBITDA ("limitation amount"). The excess of net interest expense over the limitation amount ("excess interest") can be carried over to and be deducted in future years, to the extent of the limitation amount available in those years. Initially the bill provided for a 5 year-carryover period, increased to 10 years for the excess interest accrued in the first three years of the application of the new rules. In its final version, the Budget law allows for indefinite carryover. Similarly, beginning from 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 increase the ability of the latter to deduct its own net interest expense. For this purposes, a tax group includes foreign affiliates that would qualify for consolidation under 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 pass the partnership's losses through to the corporate partners has been immediately curtailed by the legislator, who enacted an anti-abuse rules according to which a partner's share of 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).

Based on the literal meaning of the statute, the anti-abuse rule does not apply to limited liability companies that elect to be treated as partnerships under Italy's check the box rules.

Banks, financing and insurance companies are outside the scope of the new limitation on interest deductions.

TAX CONSOLIDATION

Tax consolidation rules took effect in Italy on 1.1.2004 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, computes the total consolidated taxable income or loss of the group, and either pays the tax due or carryover or claim a refund for the excess taxes paid in advance during the tax year. Group affiliates' tax credits, withholding taxes and pre-consolidation

excess taxes are also 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 50 per cent of stock by value and profit share and ownership of more than 50 percent of voting power or sufficient votes (even if below 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 stock by vote, value and profits share. A separate set of rules applies to 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 intra-group dividends and gains from intra-group transfers of appreciated assets. As a result of the adjustment, intra-group dividends were totally nontaxable. For intra-group transfers of assets, the transferee member of the group would take a carryover basis in the transferred assets and taxation of gain would be deferred.

Under the new rules, intra-group dividends are partially taxable (5 percent), like dividends distributed outside of a tax consolidated group, and transfer of appreciated assets is a taxable transaction unless it qualifies for non recognition 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 case of termination of worldwide consolidation the tax losses of foreign affiliates deducted by the group are recaptured, to the extent of dividends paid by or gains realized from the sale of stock of such foreign affiliates after termination of consolidation.

OFF BALANCE SHEET DEDUCTIONS

Under previous law, certain costs (depreciation, write downs and devaluation, 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 of 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 accounted for and deducted also 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 book deduction under prior law can be recaptured, with realignment of tax basis of the assets or items they refer to, with payment of a substituted tax at the same rates of 12, 14 and 16 percent that apply to the basis step up in tax-free reorganizations.

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

DEPRECIATION DEDUCTIONS

As a general rule, 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 in the first three years of purchase of new assets or in the first year of 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 is increased to 2/3 of the depreciation schedule for the leased assets (with a minimum of eleven years and a maximum of eighteen years for immovable property).

NEW “WHITE LIST” FOR CROSS BORDER TRANSACTIONS

Under previous law, for the purposes of various anti abuse and anti deferral provisions of Italian tax code (including rules on controlled foreign companies, denial of deduction for costs incurred in transactions with foreign entities, full taxation of dividends and stock gains from foreign entities, increase in withholding tax on outbound interest payments and exemption of Italian source portfolio income of foreign taxpayers) the tax administration had adopted a list of low tax jurisdictions referred to as “black list”, which triggered the application of the anti abuse provisions.

The 2008 Budget Law provides that the “black list” will be replaced by two separate “white lists” of jurisdictions that will be outside of the scope of the anti-abuse provisions referred to above. The white lists shall be adopted with a decree to be issued by the Ministry of Economy and Finance pursuant to the criteria set forth in the Budget Law.

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

For the purposes of the rules on controlled foreign companies, full taxation of foreign dividends and gains and general anti-avoidance provisions, the new “white list” shall be based on both the existence of an exchange of information system with and the level of taxation existing in the foreign country, which should not be significantly lower than the Italian tax. The statute does not prescribe any minimum threshold.

PUBLICLY TRADED REAL ESTATE INVESTMENT COMPANIES (SIIQ)

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

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

Also, with respect to the publicly traded requirement, it is provided that at least 35 percent of a REIC 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), and the requirement is tested at the time of the election. Consequently, any post election 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

The Law Decree n. 223 of July 4, 2006 had tightened the rules on non-operating companies by reducing the minimum thresholds for applying non-operating company status and increasing the non-operating companies' imputed taxable income.

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

The minimum imputed taxable income was fixed at 1.5 per cent of the value of stock, 4.75 per cent of the value of real estate and 12 per cent 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 the above rules and extended the non-operating company regime to IRAP. The changes retroactively applied from July 4, 2006.

To counter balance the tightening of the rules, the 2007 Budget Law introduced a favorable tax treatment to taxpayers who wanted to liquidate their non-operating companies.

Eligible companies include non-operating companies as of July 4, 2006 that do not meet the minimum revenue threshold but have income above the minimum imputed income, whose shareholders are exclusively individuals. For that purposes, 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. Transfer of shares among existing shareholders does not affect the treatment of the liquidation.

The favorable tax treatment of the liquidation consists in reduced corporate income taxation and elimination of shareholder level tax.

In particular, gains realized and income recognized in liquidation is taxed at 25 per cent flat tax rate, in lieu of ordinary corporate income tax and IRAP that would otherwise apply (at a combined rate of 37.5 per cent).

For the purpose of computing the gain realized upon the transfer of 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 to the shareholders (as dividend, if out of the company's profits, or 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 upon before May 30, 2007.

The 2008 Budget Law extended the liquidation of non-operating companies up to May 30, 2008 for calendar year taxpayers, **or five months after the end of tax year in course as of December 31, 2007. Also, it has enacted further exclusions to the application of non-operating company's regime, for companies with more than 50 shareholders, or gross receipts exceeding gross assets or at least ten employees on average during the two preceding tax years.**

DEDUCTION OF INTEREST FOR REAL ESTATE COMPANIES

Under prior 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 fixed allowance on account of costs, with all other costs in excess of the fixed allowance deemed nondeductible and disallowed.

A provision of 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 provision for the correct interpretation of prior law. As such, it should apply retroactively and may lead to tax refunds.

