Italy adopts legislative decree implementing EU anti-tax avoidance package

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In brief

The Italian Legislative Decree n. 142/2018 (the Italian ATAD Decree) enacting the EU anti-tax avoidance package was published in the Italian official gazette on December 28 2018.

The Italian ATAD Decree transposes EU Directive 2016/1164 (ATAD 1) – as amended by EU Directive 2017/952 (ATAD 2) – into the Italian legal system by providing rules against the erosion of taxable bases in the internal market and the shifting of profits out of the Italian market.

The Italian ATAD Decree contains the ATAD 1 and ATAD 2 provisions covering (i) interest limitation rules; (ii) exit taxation; (iii) entry taxation; (iv) controlled foreign company (CFC) rules; (v) a new set of criteria to identify 'tax haven'; and (vi) EU and extra-EU anti-hybrid rules. According to the Italian ATAD Decree, most of the provisions apply starting in fiscal year 2019.

The Italian Legislator did not transpose the general anti-abuse rule under Article 6 of ATAD 1 since the current Italian general anti-abuse provision, enacted in 2015 (art. 10-bis of Law no. 212/2000), is considered to be mostly in line with the EU rule.

Most of the Italian ATAD Decree provisions triggered amendments in the Italian tax code (ITC).

In detail

Interest limitation rules – amendment of Article 96 of the ITC

Generally, interest expense is deductible up to an amount equal to the interest income accrued. Any excess over that threshold is deductible up to 30% of EBITDA (earnings before interest, taxes, depreciation, and amortization). Amendments to the interest limitation rules that apply beginning with fiscal year 2019 primarily consist of the following provisions.

Affected interest expense

Relevant interest expenses are those that (jointly):

- qualify as such according to applicable GAAP, i.e., generally accepted accounting principles (GAAP provides for the substance-over-form principle consistent with OECD BEPS Action 4, and the Italian income tax decree confirms the above qualification), and
- arise from transactions or contractual relationships having a financial purpose or with a relevant financial component.

The new interest limitation rules also apply to interest:

1. capitalized in the cost of assets (including inventory)
2. accruing on trade payables
3. incurred by real estate companies on mortgage loans. ***Note:*** *this extension, however, is put on hold by Article 1(7) of Law No. 145 of 30 December 2018 until the future reform of the tax regime applicable to real estate companies; therefore, this interest currently is still outside the scope of the interest limitation rule.*

The new rules also apply to bond issuance costs that used to be deductible on a cash basis without any limitations.

Observation: The Italian income tax decrees therefore may not confirm the interest qualification of certain interest expenses from an accounting perspective, such as interest on repurchase agreements of shares/other participating financing instruments; virtual interest on non-interest bearing loans granted to controlled companies; the interest component on actualization of provisions; and contingent liabilities (IAS 37).

Even in the absence of a similar provision in the EU ATAD Directive, expenses incurred and income derived from participating financial instruments (PFI) - even though the PFI qualifies as an equity investment according to the applicable GAAP - are qualified as interest expense or income provided that they are deductible/taxable in the hands of the issuer/recipient.

Excess of borrowing/interest costs

Excess borrowing costs are deductible up to 30% of EBITDA. EBITDA is determined on the basis of the annual profit and loss statement– including gain or loss derived from the disposal of ongoing concerns- adjusted to take into account relevant income tax upward/downward adjustments (tax-adjusted EBITDA). Companies that have made a patent box regime election should reduce EBITDA by the amount of income that is exempt under such regime.

Interest and EBITDA carryforward

New interest limitation rules provide that:

- Excess interest expense as well as excess interest revenue in a given year can be carried forward to future fiscal years without any time restriction. ***Note:*** This Italian provision contradicts EU ATAD, which does not provide for the possibility of interest income in excess of interest expense.
- Excess 30% tax-adjusted EBITDA can be carried-forward for five taxable periods; a first-in first-out (FIFO) approach applies. A carryback is not allowed.

Transitional regime

The following specific transitional rules apply:

- Excess interest expense as of December 31, 2018 can be indefinitely carried forward and deducted under the new regime beginning in 2019 (no time limitation).
- Excess 30% EBITDA as of December 31, 2018 can be used only to deduct interest expense on loan agreements concluded before June 17, 2016, provided that no amendments were made after June 17, 2016 to the duration of the loan/amount of interest (the grandfathering clause). If any amendments occurred, the excess 30% EBITDA can be used only to offset the interest expenses that would have been charged based on the original agreement.
- The transition from a rule based on the accounting EBITDA (in force up to 2018) to a rule based on the tax-adjusted EBITDA (in force starting from 2019) requires specific provisions aimed to prevent situations of double-computation/exclusion of a single item (due to the timing differences between the P&L and income taxable basis).

Other

Note: Italy has not implemented the *de minimis* rule, the stand-alone escape, or the equity escape provisions provided by ATAD I.

Observation: A specific provision has been introduced that excludes interest expense on loans used to fund long-term public infrastructure projects from the interest limitation rule where the project operator, borrowing costs, assets, and income are in the European Union. However, the Italian rule appears to have additional requirements that EU ATAD does not require, thereby restricting access to such regime (such as a requirement that loans shall be collateralized only by assets owned by the project operator).

Exit and entry taxation – amendments of Article 166 and 166(bis) of the ITC

The new exit tax regime applies beginning with fiscal year 2019.

Exit taxation

The new exit tax regime applies to:

- transfers of assets from an Italian head office to its foreign permanent establishments (PEs) to the extent that the Italian company

has made the branch exemption regime election

- transfers of some assets of an Italian PE to the head office or to a foreign PE
- migration of an Italian entity's tax residence abroad unless the assets are allocated to an Italian PE
- transfers of business carried on by an Italian PE to a third country
- outbound cross-border transactions (i.e., mergers, demergers, contributions) falling within the scope of the EU Merger Directive unless the assets are attributed to an Italian PE.

In line with ATAD 1, the exit tax regime also applies to the transfer of a single asset (the scope of the old rule was limited to the transfer of a going concern).

Deemed capital gain subject to exit tax shall be determined as the difference between the arm's-length value (*see* the OECD Transfer Pricing guidelines) and the tax basis of the assets/going concern transferred abroad. In case of a transfer of going concern, the market value includes any embedded goodwill. Specific rules govern the carryforward of taxable loss for offsetting the deemed capital gain arising at the time of the exit.

In line with ATAD 1, the new regime does not allow deferral of exit taxation. In the event the destination country is an EU member state or an European economic area (EEA) country, the taxpayer has the option to pay the exit tax in five annual installments to the extent a specific guarantee is provided. Interest is charged on the installments. Several events may trigger the interruption of the payments through installments.

Entry taxation

The entry tax regime mirrors the provisions provided under the exit tax regime. Therefore, the valuation criteria (i.e., fair market value) of assets and business apply.

CFC rules – amendment of Article 167 of the ITC

In line with Article 7 of ATAD 1, Article 4 of the Italian ATAD Decree introduces the new CFC regime, applicable beginning with fiscal year 2019.

CFC definition

A foreign entity is deemed to be controlled if the Italian taxpayer (including both companies and individuals):

- owns, directly or indirectly, more than 50% of the voting rights or
- owns, directly or indirectly, enough voting rights, even if lower than 50%, to exercise dominant influence in the shareholders' meeting or
- is entitled to more than 50% of the foreign entity profits, either directly or indirectly through other controlled companies.

Observation: The definition of relevant control is the same provided by the Italian Civil Code (which includes legal control, de facto control, and contractual control). Hence, the definition of control provided by the Italian ATAD Decree appears to be broader since it includes de facto and contractual control situations not contemplated by the EU directive.

'Foreign entity' also includes PEs of CFCs and PEs of Italian taxpayers that opted for the branch exemption regime. The CFC regime applies if both the following conditions are jointly met:

1. the **effective tax rate** of the foreign entity is lower than 50% of the Italian virtual one and
2. more than one-third of the foreign entity **revenues** are passive in nature.

The CFC rules also apply to **PEs of CFCs** in the event business income derived by the former is either not subject to tax or exempt in the CFC's jurisdiction. In this case, the comparison of the effective taxation under 1) above works differently depending on whether:

- Business income of the PE is exempt from tax in the resident state of the foreign controlled company; in this case two tests need to be performed:
  - a) one for the foreign controlled company and
  - b) the second for its PE.
- Business income related to the PE is taxed in the resident state of the foreign controlled company; in this case, only one test needs to be performed considering both the income and taxes paid by the PE and the foreign controlled company.

Passive income definition

For CFC purposes, revenues that qualify as passive in nature are:

- interest or any other income generated by financial assets
- royalties or any other income generated from intangible property
- dividends and income from the disposal of shares
- income from financial leasing
- income from insurance, banking, and other financial activities

- income deriving from low-or-nil-economic-value sales of goods by companies that, directly or indirectly, control - or are controlled by - the CFC or are controlled by the same entity that controls the CFC
- income deriving from low-or-nil-economic-value provisions of services rendered to entities that, directly or indirectly, control - or are controlled by - the CFC or are controlled by the same entity that controls the CFC.

In order to identify the services or sales with a nil- or low-economic value, the arm's-length principle shall serve as a reference.

CFC taxation

Regardless of any profit distribution, the CFC's overall income is recaptured and shall be determined according to the relevant Italian tax code provision (some exceptions apply) and separately subject to tax in Italy only on the proportion corresponding to the Italian taxpayer's profit rights. The applicable tax rate equals the average tax rate applied on the shareholder's aggregate income; however, the average rate cannot be lower than the ordinary corporate income tax rate (24%).

The Italian CFC regime is not entirely aligned with ATAD 1, which provides for a transaction-based income calculation, and with BEPS Action 3.

Tax paid by the CFC or by the PE can be deducted according to the Italian foreign tax credit (FTC) mechanism.

Disapplication of the CFC regime – no mandatory advance tax ruling

An Italian taxpayer may disregard the CFC regime to the extent it provides evidence that the foreign controlled entity carries on **substantial economic activity** supported by staff, equipment, assets, and premises. **An advance tax ruling** can be filed in order to disregard the CFC regime. Such a ruling is optional, and even if there is a negative outcome, the taxpayer may disregard the CFC regime. If the CFC rules apply, the validity of the branch exemption option is subordinate to satisfying the effective economic activity test.

Mitigation of double taxation in case of a distribution and disposal – credit of foreign taxes

Distributed profits (i.e., dividends) that already have been subject to CFC taxation are excluded from the taxable base of the resident company or, if the CFC rule has been disregarded (see above section on disapplication of the CFC regime paragraph), are taxed at only 50% of the relevant amount (an indirect FTC is recognized).

Capital gains on a CFC disposition are taxed in Italy. However, taxes paid on the CFC profits may be credited according to the FTC mechanism, provided that the Italian taxpayer is able to prove that the CFC conducts substantive economic activity.

Interests in entities resident in low-tax jurisdictions – new Article 47-bis of the ITC and amendments of the ITC-specific provisions

Article 5 of the Italian ATAD Decree introduces new criteria to assess whether a company is considered resident in a low-tax jurisdiction for purposes of capital gains and dividends taxation.

Capital gains and dividends derived, directly or indirectly, from entities resident in a country with tax-privileged regimes are fully taxed in the hands of the Italian shareholder. In any case, EU and EEA member States cannot be considered countries with privileged tax regimes.

In particular, a foreign entity is deemed to be resident in a low-tax jurisdiction (i.e., qualifies as privileged) if:

- in the case of a controlling situation (to be defined according to the CFC rule), a tax regime qualifies as privileged if the foreign effective tax rate is less than 50% of the Italian virtual rate (the CFC rule is referenced)
- in the case of a non-controlling situation, a tax regime qualifies as privileged if the foreign nominal tax rate is less than 50% of the rate applicable in Italy (i.e., 27.9% for corporate taxpayers); in addition, privileged tax regimes also may include special tax regimes that do not apply to all taxpayers carrying on the same business activity but apply only on a subjective or temporary basis; indeed, even though 'special tax regime' does not imply a reduction in the nominal tax rate, it provides for exemptions/reductions in the income taxable basis of the foreign company that ultimately has the same effect that would have a nominal tax rate 50% less than the Italian one.

Profits derived from a privileged tax regime are fully taxed unless already taxed in Italy pursuant to the CFC regime.

Some profits are not fully taxed (i.e., taxed according to the ordinary rule) where one of the two safe harbor rules is invoked:

1. if it can be proven that, from the beginning of the holding, the participation in the foreign entity does not result in **shifting income to privileged tax regimes**

2. if it can be proven that the CFC carries on a **substantial business activity**.

In either case, if the shareholder is a corporate shareholder subject to corporate income tax, 50% of the dividend amount will be excluded from taxable income, and the foreign tax credit can be claimed to remove double taxation on the residual dividend amount. If the shareholder is not a corporate shareholder subject to corporate income tax, a foreign tax credit on the whole amount is the only existing alternative to remove double taxation.

Similar provisions apply to remove double taxation in the case of capital gains. Generally, beginning in 2019, capital gains on the disposal of shareholdings in Italian entities realized by a non-resident shareholder are subject to a 26% withholding tax; tax treaty provisions (art. 13 of the OECD Model Tax Convention) apply. However, there is an exception, since capital gains on the disposal of nonqualified public-listed shareholdings in Italian entities, realized by a non-resident shareholder, are not subject to tax in Italy.

Hybrid mismatches

The Italian ATAD Decree transposes the ATAD 2 Directive into the Italian legal system. The Italian Decree generally aligns with the ATAD 2 Directive provisions, with a few discrepancies in the enacted Italian anti-hybrid rules (that mostly relate to the definition of taxpayer, which seems to be broader).

When will the new anti-hybrid rules enter into force?

The rules are effective for fiscal years beginning on or after January 1, 2020, except for the rules targeting the reverse hybrids mismatch, which will be effective for fiscal years beginning on or after January 1, 2022.

What is the relevance of the BEPS Reports?

The Explanatory Note to the Italian ATAD Decree is aligned with point 28 of the Preamble to the ATAD 2 Directive, as it considers the 2015 Report Neutralising the Effect of Hybrid Mismatch Arrangement and the 2017 Report Neutralising the Effects of Branch Mismatch Arrangements as 'supplementary means of interpretation.'

Observation: Thus, to the extent that the Reports' conclusions do not conflict with the Italian ATAD Decree provisions, they provide clarity for Italian taxpayers.

What do the new anti-hybrid rules target?

Under Italian ATAD Decree, hybrid mismatches can be broadly categorized under two categories:

- Deduction and non-inclusion mismatch (**D/NI**): arises when a payment results in a deduction in one jurisdiction with no corresponding inclusion in the taxable base of the recipient located in the other jurisdiction. The D/NI must derive from the different tax treatment (regardless of the legal qualification) of an instrument, entity or branch.
- Double deduction (**DD**): occurs when taxpayers are entitled to a deduction in two countries for the same payment.

D/NI and DD hybrid mismatches can arise in several ways involving financial instruments, hybrid entities or branches. The Italian ATAD Decree (in line with the ATAD 2 Directive) identifies a number of different ways a mismatch can arise and develops specific rules to neutralize each of them, namely, (i) use of hybrid financial instruments; (ii) disregarded hybrid payments; (iii) structures producing double deductions; (iv) reverse hybrids; (v) dual-resident entities; (vi) imported mismatches; and (vii) deemed branch payments and payee mismatches.

Who is subject to the anti-hybrid rules?

Broadly speaking, the new anti-hybrid rules apply to all Italian taxpayers subject to corporate income tax in Italy, including PEs located in Italy of non-resident companies, business partnerships treated as fiscally transparent under Italian law, and individual entrepreneurs. The latter category of taxpayer is not contemplated under ATAD 2; thus, in this respect the definition of taxpayer under the Italian Decree is broader.

The rules apply to mismatches occurring between taxpayers considered to be associated enterprises or arising in the context of a structured arrangement between two non-associated taxpayers. The notion of control and structured arrangement is mostly in line with the ATAD 2 definition.

Territorial scope of the anti-hybrid rules

In line with point 11 of the Preamble to ATAD 1, the Explanatory Note to the Italian ATAD Decree specifies that the new anti-hybrid rules are intended to address only cross-border mismatches and do not apply to mismatches arising between two taxpayers both resident for tax purposes in Italy. ***Observation:*** In this respect, domestic mismatches fall within the application of the Italian general anti-abuse provision. Thus, the mismatches falling within the scope of the Italian ATAD Directive are those that arise between

taxpayers resident or located in Italy, and taxpayers resident or located either in an European member state or in a third country.

How is the mismatch eliminated?

For a **D/D** mismatch, the mismatch is eliminated if Italy qualifies as the **State of the investor** and denies the expense deduction to the Italian taxpayer (**primary rule**). If Italy qualifies as the State of the payer and the expense deduction is not denied by the State of the Investor, Italy applies secondary rules (i.e., denies the expense deduction to the Italian taxpayer).

For a D/NI mismatch, the mismatch is eliminated if Italy qualifies as the State of:

- the payer and denies the expense deduction to the Italian taxpayer (**primary rule**) unless the mismatch is neutralized in another State
- the beneficiary and the expense deduction is not denied in the State of the payer, the corresponding amount of revenues are included in the taxable base of the Italian taxpayer and taxed accordingly (secondary rule), unless the mismatch is not neutralized in another State.

The takeaway

The main Italian ATAD Decree amendments to Italian tax rules relate to:

- changes in the interest limitation rule
- updates of the Exit and Entry tax provision
- changes in controlled foreign entities rules (CFC regime)
- updates on the definition of low-tax regime jurisdictions
- introduction of anti-hybrid rules in the Italian tax system.

Multinationals should consider the potential impact of the Italian ATAD Decree, analyze their position for Italian tax purposes, and consider the relevant anti-avoidance rules that have been introduced beginning in fiscal year 2019.

Let's talk

For a deeper discussion of how this might affect your business, please contact:

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