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8 Bouverie Street
London EC4Y 8AX UK
Tel: +44 20 7779 8308
Fax: +44 20 7779 8500

Managing editor Anjana Haines
anjana.haines@euromoneyplc.com

Commercial editor Prin Shasiharan
prin.shasiharan@euromoneyplc.com

Deputy editor Josh White
josh.white@euromoneyplc.com

Senior reporter Mattias Cruz Cano
mattias.cruz@euromoneyplc.com

Reporter Danish Mehboob
danish.mehboob@euromoneyplc.com

Production editor João Fernandes
jfernandes@euromoneyplc.com

Head of business development Margaret Varela-Christie
margaret.varela-christie@euromoneyplc.com

Head of business development – Events Jamil Ahad
jamil.ahad@euromoneyplc.com

Business development executives
Raquel Ipo raquel.ipo@euromoneyplc.com
Alexandra Strick alexandra.strick@euromoneyny.com

Subscriptions manager Jack Avent
jack.avent@euromoneyplc.com

Head of editorial David Braid
david.braid@legalmediagroup.com

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Customer services: +44 20 7779 8610

UK subscription hotline: +44 20 7779 8999

US subscription hotline: +1 800 437 9997

Defying age through versatility

Prin Shasiharan
Commercial editor
ITR

Italy takes pride in tinkering its way to tax efficiency, frequently taking an alternative approach from its Western European counterparts.

In the coming years, we can expect the notional interest deduction regime to be reinstated and the reduced corporate income tax rule to be repealed. New indirect taxes have already been proposed for plastic and sugar, while a revamp of the VAT rate is regularly debated.

As Italy's legislators deliberate tax policies to keep up with the evolving market, the demand for expert advice remains high. The unforeseen outbreak of COVID-19 means that authorities and taxpayers are already preparing for another unexpected challenge.

Partnering with leading tax advisors, *ITR* brings you an exclusive insight into some of the most significant recent developments from the Italian tax world.

The resurgence of high-level private equity work in Italy is the subject considered by Belluzzo International Partners. European regulations and national tax rules have effectively paved the way towards a clearer framework for investors.

Loconte & Partners discuss how Italy seeks to mitigate economic double taxation and remain attractive to foreign companies, while taking note of changes triggered by the EU Anti-Tax Avoidance Directive (ATAD).

In the area of transfer pricing (TP), the number of advanced pricing agreement (APA) requests registered have increased year-on-year in stark contrast to the pattern in France, Germany and the UK. Studio Legale Tributario EY examine how Italy can take multiple benefits from the distinctive strategy.

Mutual agreement procedure (MAP) cases have also risen because of the increased scrutiny on tax risks deriving from TP matters. LED Taxand explore how tax authorities are progressively aligning with international standards.

Alongside agreement schemes, Italy is actively embracing technological innovation. Hager & Partners look at how businesses can gain from tax incentives designed to promote the markets of tomorrow.

Over 2000 years in the making, Italy's tax system will likely continue to transform in the 2020s. We hope that you find the second edition of our Italy guide beneficial.

Italy

Italy's taxation of foreign companies: New rules and a recent judgment

Stefano Loconte and Emanuele Tozzi at Loconte & Partners explain the key amendments to Italy's taxation of dividends paid by foreign companies, which have come to the fore following the implementation of the EU's Anti-Tax Avoidance Directive (ATAD).

The rules in Italy on the taxation of dividends distributed by foreign entities to resident companies and other commercial entities have been amended following the transposition within Italian tax law of the EU Anti-Tax Avoidance Directive (ATAD) (Directive 2016/1164/EU). The amendments apply from fiscal years beginning on or after January 1 2019.

In addition, a recent judgment of the Italian Court of Cassation clarified the application of double tax treaties to dividend distributions.

The general rule

In order to mitigate economic double taxation – the simultaneous taxation of the company's profits at the level of the company and of the dividends at the level of a shareholder – the Italian domestic tax system provides relief at the shareholder's level. In other words, the distributing company (resident in Italy) is taxed on its total profits, whether distributed or not, and the dividends are taxed also in the hands of its resident company shareholder, but only for a small part. This shareholder's relief is extended to distributions from foreign entities if the distributing entity is not a resident in a country applying privileged tax regimes.

In particular, as a general rule, 95% of the dividend amount received by companies and other commercial entities resident in Italy are excluded from taxation. The ordinary rate (24%) applies to the amount subject to tax (5%), which gives an effective tax rate of 1.2%.

Dividends distributed by foreign entities are subject to the above general rule if the dividend is not deductible from the taxable base of the entity that distributes such dividends.

The above exemption is consistent with the provisions of the EU Parent-Subsidiary Directive (Directive 2011/96/EU). Article 4, paragraph 1 of the directive states: "Where a parent company or its permanent establishment, by virtue of the association of the parent company with its subsidiary, receives distributed profits, the member state of the parent company and the member state of its permanent establishment shall, except when the subsidiary is liquidated, either: (a) refrain from taxing such profits; (b) […]".

Further, the partial taxation of dividends can be related to EU law and, in particular, to Article 4, paragraph 3, which states: "Each member state shall retain the option of providing that any charges relating to the holding and any losses resulting from the distribution of the profits of the subsidiary may not be deducted from the taxable profits of the parent company. Where the management costs relating to the holding in such a case are fixed as a flat rate, the fixed amount may not exceed 5% of the profits distributed by the subsidiary."

It must be noted, however, that the above treatment is extended to distributing entities resident in non-EU countries and it is not subject to a minimum holding of 10% in the capital of a company, as required by the Parent-Subsidiary Directive to be qualified as a parent company.

The exceptions

The above general rule is subject to two exceptions:

1. Shares and similar financial instruments held for trade by International Financial Reporting Standards (IFRS) adopters, which are fully taxable; and
2. Dividends distributed by companies resident in countries applying privileged tax regimes received directly by the Italian shareholder or indirectly through a (controlled) foreign subsidiary, which are fully taxable, unless one of the two exemptions below are satisfied.

In any case, profits of foreign companies taxed in Italy according to the controlled foreign company (CFC) rules are not taxed as dividends in the hands of the receiving company at the time of the distribution.

Privileged tax regimes

The tax regime of a country (other than an EU country and a European Economic Area (EEA) country, which grants effective information exchanges) is considered privileged, with reference to controlled entities, if the effective tax rate is lower than 50% of the one applicable in Italy. The same is applicable for non-controlled entities if the nominal tax rate is lower than 50% of the one applicable in Italy. Also, for such non-controlled entities, special tax regimes not directly affected by the nominal tax rate must be considered in the determination of the privileged nature of the tax regime.

The two exemptions

In order to prevent the application of the special rules concerning privileged tax regimes, there are two exemptions:

a) A taxpayer can demonstrate that the non-resident entity carries on substantive economic activity supported by staff, equipment, assets and premises; and
b) The taxpayer can prove that from the shareholding, they do not derive the effect of localising the income in countries with privileged tax regimes.

The above two exemptions can be ascertained also through a ruling with the Italian tax authorities.

If the taxpayer can prove the effective economic activity of the foreign entity, i.e. exemption (a) above, the general 95% exclusion rule will apply. In addition, if the taxpayer can only prove that from the shareholding, he does not derive the effect of localising the income in countries with privileged tax regimes, i.e. exemption (b) above, 50% of the dividend amount will be taxed. In this case, the taxes paid by the foreign entity on its profits (typically the corporate income tax) can be deducted from the tax due by the Italian parent according to the ordinary credit method, but the gross taxable income must include this foreign tax credit.

The above provisions, with reference to the identification of privileged tax regimes and the related exemptions, are consistent with the CFC rules, which have been amended in Italy as a consequence of transposing the ATAD into domestic law.

The foreign tax credit

With reference to dividends subject to withholding tax in the source country, in order to prevent double taxation, Italian tax law states that income taxes paid abroad on a final basis can be deducted from the tax due in Italy. However, the amount of the deduction may not exceed that part of the Italian tax attributable to those items of income in the ratio of those items to the total income (ordinary credit). If the income is produced in several foreign countries, the foreign tax credit is calculated separately for each country (per country limitation). Any foreign tax, which exceeds the tax credit amount, can be carried back and forward for eight years and used to offset any excess Italian tax, calculated according to the above-mentioned ordinary credit method.

In case the foreign-sourced income is only partially included in the total taxable income in Italy (as it is the general case for dividends), the foreign tax must be reduced by the same proportion.

Applying double tax treaties and a recent Court of Cassation judgment

Generally, double tax treaties signed by Italy follow the OECD Model Tax Convention (OECD model) and, to eliminate double taxation, usually provide for the ordinary credit methods similar to the domestic rules described above.

Recently, the Italian Court of Cassation (Case No. 29635/2019) dealt with a case concerning the application of a double tax treaty, which uncommonly provided for a

Stefano Loconte

Managing partner

Loconte & Partners

Tel: +39 080 5722880

stefano.loconte@studioloconte.it

Stefano Loconte is a senior Italian lawyer qualified to practice before the Court of Cassation. He is the founder and managing partner of Loconte & Partners.

His areas of practice include corporate, commercial, tax, business contracts and international law. Moreover, he has gained specific and high-level experience in trust law and he is the author of several published articles in the subject.

He is a university professor of tax law, trust law and Islamic finance at the faculties of economics and law at the LUM Jean Monnet University, Casamassima and has worked as a professor at countless courses and seminars organised by leading Italian universities. He is a member of the Society of Trust and Estate Practitioners (STEP Italy) and member of the STEP academic community.

Finally, he is also the global chairman of the Geneva Group International (GGI) alliance 'trust and estate planning' practice group.

Emanuele Tozzi

Senior associate

Loconte & Partners

emanuele.tozzi@studioloconte.it

Emanuele Tozzi is a senior associate at Loconte & Partners, with several years of experience in consultancy and in assisting on direct and indirect taxation for companies, financial entities, trusts, and high-net-worth individuals.

In 2016, he obtained the advanced diploma in international taxation (ADIT) issued by the UK Chartered Institute of Taxation (CIOT). In 2011, he completed his graduation in international taxation and financial services (JSM) at the Thomas Jefferson School of Law (San Diego, California).

In 2009, he qualified as a chartered accountant (Dottore Commercialista) and as a registered auditor (Revisore Contabile) in Italy, after graduating in 2004 with a degree in business administration at Pisa University (Italy).

complete exemption from the tax base of the Italian shareholder of dividends received from a foreign entity, which was German.

In particular, the Italy-Germany treaty states that income from dividends will be excluded from the base upon which Italian tax is levied. This is the case if the dividends are paid to a company (not including partnerships) being a resident of Italy by a company being a resident of Germany, where at least 25% of the capital is owned directly by the Italian company.

In the mentioned case, the Italian tax authorities denied the application of the above full exemption, assuming that the treaty was aimed at eliminating only juridical double taxation, which did not take place because the dividend was not subject to withholding tax in Germany. The Italian tax authorities disregarded the fact that the distributing entity was subject to corporate income tax in Germany and that, if Italy had taxed the dividend, economic double taxation would have occurred.

It must be remembered that the provisions of the OECD model deal only with the so-called juridical double taxation, where the same income or capital is taxable in the hands of the same person by more than one state. This case has to be distinguished from the so-called economic double taxation, where two different persons are taxable in respect of the same income or capital. The commentary to the OECD model indicates that if two states wish to solve problems of economic double taxation, they must do so in bilateral negotiations.

The court underlined some important principles, starting from the rules regarding the interpretation of treaties to be applied to the term 'double taxation'.

The convention between Italy and Germany states that any term not defined therein shall, unless the context otherwise requires, have the meaning which it has under the law of that state concerning the taxes to which the convention applies. Accordingly, in the case at hand, the term 'double taxation' should be interpreted according to Italian tax law and jurisprudence which refer only to 'juridical double taxation' and does not prohibit 'economic double taxation' (although it limits dividend taxation to 5% of their amount).

However, on this point, the Italian Court found the interpretation of the European Court of Justice in C-648/15 at paragraph 35-39 relevant, which stated that the terms of the convention must be interpreted according to the methods defined in international law. In that regard, the provisions of the Vienna Convention must be adhered to, which states that a treaty must be interpreted in good faith in accordance with the ordinary meaning to be given to its terms in their context and in the light of its object and purpose.

Accordingly, the literal interpretation of the Italy-Germany treaty means that the dividend exemption is unconditional, and not subject to any taxation of the dividend in the source country.

Furthermore, the Cassation Court acknowledged that, also according to its jurisprudence, the OECD model and its commentary have a relevant interpretative function. As mentioned above, the commentary states that although the provisions of the model do not prevent economic double taxation, the states interested in addressing such a problem may include specific rules in their actual agreements.

According to the court, since the OECD model does not contain an exemption provision similar to the one included in the Italy-Germany treaty, this difference can be seen as a significant indication that the parties agreed to address economic double taxation, as recommended by the commentary to the OECD model.

The Cassation Court also commented on the relation between domestic and conventional rules, confirming the overriding status of the latter, considering the international obligation assumed by the state, and according to its character of *lex specialis*.

Finally, the Cassation Court interpreted the relation between the conventional provision at stake and the EU law, with specific reference to the Parent-Subsidiary Directive. The applicability of the treaty is confirmed by Directive 90/435/EEC, which states: "This Directive shall not affect the application of domestic or agreement-based provisions designed to eliminate or lessen economic double taxation of dividends, in particular provisions relating to the payment of tax credits to the recipients of dividends."

Furthermore, the court quotes Directive 2003/123/EC, according to which: "When corporate groups are organised in chains of companies and profits are distributed through the chain of subsidiaries to the parent company, double taxation should be eliminated either by exemption or tax credit. In the case of tax credit the parent company should be able to deduct any tax paid by any of the subsidiaries in the chain provided that the requirements set out in Directive 90/435/EEC are met."

Considering the above, the Cassation Court decided that the exemption method provided for by the Italy-Germany treaty to eliminate double taxation in the case of dividend distributions must be applied when the dividends are not subject to withholding tax in the source country.