KPMG

Italy: Implementation of the ATAD Directives in Italy

Tax Alert

17 January 2019

Offices

Milan
Via Vittor Pisani 31, 20124
T: +39 02 676441

Ancona
Via I° Maggio 150/a, 60131
T: +39 071 2916378

Bologna
Via Innocenzo Malvasia 6, 40131
T: +39 051 4392711

Florence
Viale Niccolò Machiavelli 29, 50125
T: +39 055 261961

Genoa
P.zza della Vittoria 15/12, 16121
T: +39 010 5702225

Naples
Via F. Caracciolo 17, 80122
T: +39 081 662617

Padua
Piazza Salvemini 2, 35131
T: +39 049 8239611

Perugia
Via Campo di Marte 19, 06124
T: +39 075 5734518

Pescara
P.zza Duca D'Aosta 31, 65121
T: +39 085 4210479

Rome
Via Adelaide Ristori 38, 00197
T: +39 06 809631

Turin
C.so Vittorio Emanuele II 48, 10123
T: +39 011 883166

Verona
Via Leone Pancaldo 68, 37138
T: +39 045 8114111

On 28 December 2018 the legislative decree (the 'Decree'[1]) by which the Italian government implemented the two EU Anti-Tax Avoidance Directives (ATAD I and ATAD II) was published in the Official Gazette.

The new rules will generally apply from the tax period subsequent to that in progress on 31 December 2018. However, the hybrid mismatch measures will apply from 1 January 2020 or, in the case of reverse hybrid measures, from 2022.

Although the final version of the Decree does not differ much from the bill presented by the government to Parliament in August 2018, it does contain some important last-minute amendments to the new interest limitation rules introduced by the bill.

Overview

The measures contained in the bill have already been analyzed in a previous KPMG tax alert from Italy: Bill to implement the ATAD Directives, dated 28 September 2018.

The new rules implement the anti-abuse measures introduced by the two ATAD Directives:

- Interest limitation rules to discourage artificial debt arrangements designed to minimize taxes
- Exit taxation rules to prevent companies from avoiding tax when relocating assets
- CFC rules to deter profit shifting to a low-tax/no-tax jurisdiction
- Hybrid mismatch rules to neutralize the effects of different tax treatments resulting from differing tax characterizations of an instrument or entity under the law of two or more jurisdictions.

Below is a summary of the main new rules introduced by the Decree.

(1) Legislative Decree no. 142 of 29 November 2018.

Analysis of the Decree by article

Interest limitation rule (article 1)

The Decree replaces the domestic rule that limits deduction of interest expenses for corporates.

— It changes the rule on the calculation of EBITDA, previously based on the book values of items A) and B) of the P&L account template set out in article 2425 of the Italian Civil Code, and now on the tax bases of these items, calculated in accordance with tax rules.

— It extends the scope of the rule to interest and similar expenses included in the cost of assets. In particular, it establishes that capitalized interest included in the book value of tangible and intangible assets in accordance with article 110(1) of the Italian Income Tax Code falls within the scope of the interest limitation rule.

— It clarifies that excess interest expenses of the year can be offset against any prior excess interest income (and not just 30% of EBITDA) carried forward.

— In compliance with ATAD 1, the Decree imposes a five-year limit on the carryforward of excess 30% EBITDA. According to the new rule, the EBITDA excess capacity must be offset on a FIFO basis.

— It expressly includes among interest income any proceeds from financial instruments issued by non-residents which are deductible from the taxable income of the issuer and are thus fully taxable to the recipient (e.g. proceeds from *juro sobre o capital próprio* issued by Brazilian companies).

— It excludes from the limitation rule interest expenses on loans used for financing long-term public infrastructure projects. This is under certain conditions, e.g. the interest expenses must be secured only by assets that belong to the project operator, the project operator must be fiscally resident in a Member State of the European Union, and the assets must be used for the realization of the long-term public infrastructure project.

— The Decree basically confirms the existing rules on the deduction of interest expenses within a tax group. These allow members of the group with excess interest expenses accrued during the tax group regime to offset them against excess 30% EBITDA of other members.

— It also confirms that the interest limitation rule does not apply to financial intermediaries and insurance companies, whose interest expenses are therefore fully or 96% deductible. For the new definition of financial intermediaries, see below.

The new rules should apply from financial year 2019. However, there are certain transitional measures. For example, the Decree provides that interest expenses incurred on loans concluded before 17 June 2016, and of a duration and amount that have not been amended since that date, are deductible up to an amount equal to the excess EBITDA capacity, calculated according to the previous accounting rules and accrued up to the tax period in progress on 31 December 2018.

The Decree does not implement certain ATAD 1 rules which are favorable to taxpayers, such as the EUR3 million threshold below which net interest can be deducted in full, or the full deduction for standalone companies.

It is remarkable that the Budget Law for 2019 has restored the full deductibility regime for interest expenses on mortgage loans taken out by real estate companies, which the Decree had previously repealed.

Exit and entry taxation (articles 2 and 3)

The Decree replaces the Italian rules on exit taxation and tax deferral with new ones that are more compliant with article 5 of ATAD 1. In brief, the new rules:

— repeal the tax-suspension mechanism and only allow the payment of taxes on the deemed gain in five instalments (instead of the previous six);

— replace the notion of 'normal value' with that of 'market value' (i.e. arm’s length);

— specify in more detail which transactions fall within their scope (e.g. transfer of residence abroad, cross-border mergers and demergers, and - a new addition - the transfer of assets by a resident taxpayer to its foreign permanent establishment subject to the branch exemption regime);

— include and update the rules contained in the implementing decree of 2 July 2014 (such as the criteria for computing taxable gains, and events that result in termination of the tax-deferral regime).

The Decree also replaces the domestic rule applicable to companies that move their residence to Italy - even though not affected by ATAD 1 - in order to make it symmetric with that on exit taxation. The Decree clarifies the criteria for determining the tax bases of items recognized upon entry.

CFC rules (article 4)

The main change made by the Decree is to eliminate the difference between the treatment of CFCs according to whether they are based in a cooperative or non-cooperative jurisdiction. The Decree provides that the resident partner is taxed on all income of a CFC located in a low-tax jurisdiction, on condition that one-third of the latter’s income is passive income.

The Decree amends the CFC rules in order to make them more compliant with articles 7 and 8 of ATAD 1 by, essentially:

— extending the notion of 'control' to a share in profits higher than 50%;

— establishing that a controlled company is a CFC if (i) its effective (no longer nominal) tax rate is lower than 50% of the tax rate that would apply if it were resident in Italy, and (ii) more than one-third of its income is passive income (there is no longer a distinction between EEA and non-EEA CFCs);

— establishing one safe-harbor rule and no longer three (to qualify for safe-harbor status, non-resident entities must carry out a substantive economic activity, supported by staff, equipment, assets and premises).

The Decree does not introduce certain ATAD 1 rules that may be more favorable to taxpayers, such as the threshold below which the CFC rules do not apply.

Rules on the taxation of dividends and capital gains from equity interests in non-resident companies (article 5)

Even though they are not directly affected by the ATAD Directives, the Decree changes the rules on dividends arising from a low-tax jurisdiction (outside the EEA), in order to align them with the amended CFC rules. Under the new rules, dividends are deemed to arise in a low-tax jurisdiction and are therefore 100% taxable to the resident shareholder if:

1. in the case of direct or indirect controlling interests (as defined for the purposes of the CFC rule - see above), the controlled company has an effective tax rate that is lower than 50% of the tax rate that would apply if it were resident in Italy;
2. in the case of other equity interests, the investee company is subject to a nominal tax rate that is lower than 50% of the domestic one (or to a special regime that leads to the same result).

The resident shareholder may avoid full taxation by applying one of the following two safe-harbor rules.

1. The CFC safe-harbor rule (substantive economic activity test - see above), which leads to a 50% dividend exemption (and a foreign tax credit, in the case of controlling interests).
2. The existing subject-to-tax test, which leads to the standard 95% exemption.

Under previous law, capital gains from the transfer of shares in entities located in a low-tax jurisdiction (outside the EEA, as defined above for dividends) were 100% taxable to the resident seller, unless the safe-harbor requirement (i.e. subject-to-tax test) had been met ever since the shares had been held. The Decree establishes that, if the purchaser does not belong to the same group as the seller (i.e. does not control, is not controlled by and is not under the same control as the seller), the safe-harbor requirement has to be met over the previous five years only. The same criterion applies to resident taxpayers for the purposes of benefitting from the participation exemption regime.

By contrast, if the substantive economic activity requirement is met, capital gains are 100% taxable but the seller is entitled to a foreign tax credit.

Hybrid mismatches (articles 6 -11)

The Decree implements the ATAD 1 anti-hybrid provisions, as amended through ATAD 2. The report accompanying the Decree clarifies that these rules must be interpreted in light of the BEPS Report on Action 2.

The Decree introduces a set of complex definitions, which precede a number of equally complex provisions effective, in general, from the fiscal year following that in progress on 31 December 2019 (i.e. from 2020, for calendar-year taxpayers).

The Decree only covers cross-border situations, while domestic ones may be challenged through the domestic GAAR. Moreover, it essentially deals with mismatches arising within the same group of companies (and related permanent establishments) and caused not just by payments related to financial instruments but also by other types of payments (e.g. those related to intangible assets) or by hybrid entities.

In brief, the Decree addresses the following situations:

— hybrid mismatches leading to a double deduction (DD) or to a deduction without inclusion (DNI);

— reverse-hybrid mismatches;

— dual-resident entities.

In the case of DD hybrid mismatches, the investor's country may deny deduction first (and only when it does not, can the payer's country deny deduction). In the case of DNI hybrids, the payer's country may deny deduction first (and only when it does not, can the beneficiary's country tax income).

The Decree excludes collective investment vehicles set up in Italy from the scope of the rules preventing reverse hybrids.

Mismatches caused by a special tax regime that a jurisdiction grants to an entity or income do not fall within the scope of these measures.

Before issuing a formal notice of assessment in connection with any one of the above situations, the tax authorities must ask the taxpayer for clarifications and explain why they are doing so.

Definition of financial intermediary (article 12)

The Decree gives a definition of 'financial intermediary' and 'industrial holding company' for the purposes of corporate income tax (IRES) and regional tax (IRAP). This new rule is important because, even though certain tax rules (e.g. the exclusion from the interest limitation rule, the 3.5% IRES surtax, the higher 4.65% IRAP rate) only apply to companies that pursue a financial activity, there is no standard definition of such entities in Italian tax law. According to the Decree:

— a financial intermediary is, essentially, (i) an Italian bank, an investment or asset management company, or a similar institution that lends money to the public and is subject to the supervision of the Bank of Italy, or (ii) a taxpayer whose exclusive or main business is the acquisition of equity interests in a financial intermediary (i.e. a financial holding company);

— an industrial holding company is one whose exclusive or main business is the acquisition of equity interests in a company other than a financial intermediary.

The Decree clarifies that, for the purposes of the above definitions, 'main' means that the book value of the equity interest, as reported in the most recently approved financial statements, exceeds 50% of the total assets.

These new definitions should be effective from 2018.

Contacts

KPMG, Tax & Legal

Fabio Avenale
Partner in charge,
Tax Professional Practice
T: +39 011 883166
E: favenale@kpmg.it

Luca Nobile
Executive Senior Advisor,
Tax
T: +39 02 6764 4792
E: lnobile@kpmg.it

kpmg.com/it

kpmg.com/it/socialmedia

kpmg.com/app

Tax Alert / KPMG in Italy / 17 January 2019