Italy: Bill to implement the ATAD Directives

Tax Alert

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In August 2018, the Italian Government published a bill to bring the anti-tax avoidance directives (the 'ATAD Directives') into Italian tax law. The bill is still under scrutiny by Parliament and may be amended before its final approval, expected by the end of 2018.

ATAD 1 (EU Council Directive 2016/1164 of 12 July 2016) contains anti-abuse rules against tax evasion by multinational companies, which Member States must adopt, in general, by 31 December 2018. It transposes into EU law the anti-avoidance principles laid down by the OECD in its BEPS Action Plan.

ATAD 1 introduces new rules to be adopted by all EU Member States in the following five areas:

— Interest limitation rules (article 4)

— Exit taxation rules (article 5)

— GAAR (article 6)

— CFC rules (articles 7 and 8)

— Hybrid mismatch rules (article 9).

ATAD 2 (EU Council Directive 2017/952 of 29 May 2017) modifies ATAD 1 as regards hybrid mismatches with third countries.

Overview

Despite its active role within the OECD BEPS project, Italy had not yet taken any official position on the status of implementation of BEPS Reports and ATAD Directives in Italian tax law. Moreover, the Italian Ministry of Finance had incidentally observed that Italian tax law is already compliant with most of the minimum standards set in the ATAD Directives[1]. Therefore, we did not expect any significant changes to current tax law. Surprisingly, however, the August bill, in the form of a draft legislative decree (the 'Decree'), significantly amends the existing rules, with the aim of aligning them with those of the ATAD Directives.

(1) See '*Nota di aggiornamento del Documento di economia e finanza 2016*'.

More specifically, the Decree replaces the tax rules on interest deduction for corporates, the exit and entry tax rules, and the CFC rules. The report accompanying the Decree clarifies that there is no need to implement the GAAR set out in article 6 of ATAD 1, as the domestic rule is already aligned with it; by contrast, Italy lacks an anti-hybrid measure.

The new rules will generally apply from the fiscal year following that in progress on 31 December 2018 (i.e. from 2019, for calendar-year taxpayers), except for those on hybrids, whose effective date is postponed. There are, however, certain transitional measures.

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

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 extends the scope of the rule to interest and similar expenses included in the cost of assets.

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

— In compliance with ATAD 1, the Decree imposes a five-year limit on the carryforward of excess 30% EBITDA, which will be computed with reference to tax (and no longer accounting) values.

— 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).

— Under certain conditions, the Decree excludes from the limitation rule interest expenses on loans used for financing long-term public infrastructure projects. Therefore, such interest expenses will be fully deductible.

— The Decree basically confirms the existing rules on the deduction of interest expenses within a tax group (which 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[2].

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[3].

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 rule:
— repeals the tax-suspension mechanism and only allows the payment of taxes on the deemed gain in five (instead of the current six) instalments;
— replaces the notion of 'normal value' with that of 'market value' (i.e. arm’s length);
— specifies in more detail which transactions fall within its 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);
— includes and updates 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[4].

CFC rules (article 4)

The Decree amends the current CFC rules[5] 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), i.e. for non-resident entities which 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 rule does not apply[6].

(2) See article 13 of the Decree

(3) See article 4(3) of ATAD 1.

(4) For an overview of existing rules, see Investment in Italy, 2018 edition, page 65.

(5) For an overview of existing rules, see Investment in Italy, 2018 edition, page 66.

(6) See article 7(4) of ATAD 1.

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[7]), 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:

i. 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;

ii. 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:

a) 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), or

b) the existing subject-to-tax test, which leads to the standard 95% exemption.

Under current law, capital gains from the transfer of shares in entities located in a low-tax jurisdiction (outside the EEA, as defined above for dividends) are 100% taxable to the resident seller, unless the safe-harbor requirement (i.e. subject-to-tax test) has been met ever since the shares have 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[8].

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).

(7) Unlike the CFC rule, this rule does not apply to equity interests in EEA companies. For an overview of existing rules, see Investment in Italy, 2018 edition, page 67.

(8) For an overview of existing rules, see Investment in Italy, 2018 edition, page 54.

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 that are 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 additional 3.5% IRES rate, 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.

Further details

For further details, please contact a KPMG advisor.

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