Italy: Updates on the application of the abuse of law rule to demergers

Tax Alert

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On 25 July 2017, the Italian Revenue Agency issued a tax ruling(1) on the application of the abuse of law rule to demergers.

Background

Under Italian tax law, demergers are tax-neutral for income tax purposes, regardless of the accounting principles adopted by the companies involved (IAS/IFRS or Italian GAAP).

For indirect tax purposes, demergers are not subject to VAT and are subject to a fixed registration tax of EUR 200(2).

The Italian Revenue Agency often used to challenge demergers followed by a transfer of shares – in the company receiving the hived-off business - by the shareholders of the demerging entity. It did so on the grounds of the former wide-scope anti-avoidance provision(3), which contained a list of 'suspect' transactions, including demergers. Its challenges were based on the deemed circumvention of the tax rules on taxable transfers of assets (or going concerns), on the absence of sound business reasons, and on the attainment of undue tax advantages(4). According to the tax authorities, the most direct or typical way of achieving the same business goal would be a straightforward sale of the assets or going concern, as opposed to a demerger followed by a transfer of shares in the newly created company that 'hosts' them, an operation that is subject to a more favorable tax regime.

For indirect tax purposes, the Revenue Agency is entitled, under article 20 of the Registration Tax Code, to reclassify transactions on the basis of their legal substance. In applying this rule, the Supreme Court often concluded that it was legitimate to reclassify - as a transfer of a going concern (subject to proportional registration tax) - a contribution of a going concern to a NewCo, followed by the sale of the shares received in exchange for the contribution (each step subject to the fixed registration tax).

(1) Resolution no. 97 of 25 July 2017.

(2) See article 4 of the Tariff of Presidential Decree no. 131 of 26 April 1986 (Registration Tax Code).

(3) Article 37-*bis* of Decree no. 600/73.

(4) See, for instance, Resolutions no. 97 and no. 256 of 2009.

In 2015, the wide-scope anti-avoidance rule was repealed and replaced by a new definition of abuse of law[(5)]. This new definition does not list the transactions that are subject to the anti-avoidance rule. It applies to all income taxes and indirect taxes (except customs duties), but only when a transaction cannot be assessed under a specific rule of law.

According to the new provision, abuse of law arises when all the following factors are in play.

a) An undue tax advantage is obtained, even without breaking any tax rule.

b) The transaction (or series of interconnected transactions) has no economic substance (i.e. though valid on paper, it is an inappropriate way of achieving the stated business goal).

c) The essential effect of the transaction is the tax advantage.

Transactions cannot be defined as abusive if they are justified by sound business reasons; these reasons include shake-ups or management decisions to improve the structure or operations of a business or professional activity.

It is up to the Italian Revenue Agency to prove that a transaction is abusive, while the taxpayer has to demonstrate that there is a sound business purpose.

If an abusive transaction is discovered by the Italian Revenue Agency, it will be disallowed for tax purposes and the tax benefits will be denied. Like the former rule, the new one establishes certain procedures that the Italian Revenue Agency must follow (e.g. the assessment notice must be preceded by a clarification request, and the taxpayer has 60 days to answer the request).

Facts and query presented in the application for the tax ruling

A company intends to carry out a reorganization, consisting in a (partial and proportional) demerger. Its real estate branch of business will be transferred to a NewCo, while the operational branch will remain with the demerging company. This transaction will be followed by a sale of shares in the demerging company (i.e. the operational branch) by its shareholders.

As mentioned above, a demerger is tax-neutral. In the reorganization described in the application, the subsequent sale of shares will be substantially tax-neutral too, as the shareholders (two individuals and a corporation) can benefit, respectively, from the step-up and participation exemption regimes.

The demerging entity asked the Italian Revenue Agency whether the planned reorganization would be an abusive transaction from a direct and indirect tax perspective.

The Italian Revenue Agency's interpretation

The Italian Revenue Agency has clarified that a demerger followed by a transfer of shares in the demerging entity is not an abusive transaction, provided that (i) it ensures the continuation of the business activity of each participating company, and (ii) the companies involved pursue actual business activities and do not only contain cash, intangibles or real estate.

The reorganization in question does not lead to an undue tax advantage, as the shareholders must be free to choose between different forms of reorganization allowed by law, having the same business goal but different tax regimes, i.e. the demerger followed by a transfer of shares, or the transfer of a going concern, or the contribution of a going concern followed by a transfer of shares[(6)].

The abuse of law rule should not be used to assess whether the reorganization results in avoidance of registration tax, as it is a residual rule, to be used only if no other specific rule applies. For registration tax purposes, article 20 of the Registration Tax Code applies. This is not an anti-tax-avoidance rule but establishes the principle that the Revenue Agency is entitled to interpret and reclassify transactions based on their real legal substance. The Revenue Agency cites recent cases where the Supreme Court[(7)] applied this rule of law and decided that reclassification (as a sale of a going concern) of a contribution of a going concern to a NewCo, followed by the sale of the shares received in exchange, was legitimate. The Italian Revenue Agency does not state its position on the case presented in the application for the tax ruling, but merely clarifies that the reorganization must be analyzed in light of article 20 of the Registration Tax Code, as interpreted by the Supreme Court.

KPMG observations

This resolution is important because it analyzes the anti-avoidance implications of company demergers in the light of the new abuse of law rule. As explained above, the tax authorities used to take the position that demergers, especially when followed by a transfer of shares, were abusive.

Now, the Italian Revenue Agency clarifies that a demerger followed by a transfer of shares may not be abusive. However, tax avoidance is only excluded if (i) the reorganization ensures the continuation of the business activity of each participating company, and (ii) the companies involved pursue actual business activities and do not only contain cash, intangibles or real estate.

(5) The new definition is set out in article 10-*bis* of Law no. 212/2000. Previously, the concept of tax avoidance was defined by article 37-*bis*, while abuse of law was defined only by case law, without any legal definition.

(6) The Italian Income Tax Code expressly states that this last transaction (a contribution followed by a sale of shares) does not constitute tax avoidance.

(7) See, for instance, judgment no. 6758 of 15 March 2017.

The Italian Revenue Agency's analysis of the registration tax implications is, by contrast, not entirely clear or favorable to taxpayers, as it cites and applies to demergers the decisions of the Supreme Court on contributions of going concerns, which are often in favor of the tax authorities. Moreover, if - as the Italian Revenue Agency says - registration tax does not fall within the scope of the new abuse of law rule, the tax authorities may, *de facto*, challenge a reorganization on the grounds of article 20 of the Registration Tax Code, without putting in place the procedural guarantees required by the abuse of law rule.

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