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Italy implements the Anti-Tax Avoidance Directive (ATAD): an overview of the main changes under Legislative Decree No. 142 of 29 November 2018

1 Introduction

On 28 December 2018 Legislative Decree No. 142 of 29 November 2018 ("**LD 142/2018**") has been published in Official Gazette No. 300, thus implementing the EU Anti-Tax Avoidance Directive 2016/1164 ("**ATAD 1**") of 12 July 2016, which lays down measures against tax avoidance practices that directly affect the functioning of the internal market (as amended by Directive 2017/952 ("**ATAD 2**") of 29 May 2017). The aim of ATAD 1 and ATAD 2 is to implement, at EU level, the BEPS (Base Erosion and Profit Shifting) proposals developed by the OECD in October 2015 under the G20 mandate (the 15 BEPS Actions), in response to the need for fairer taxation as well for the designing of rules against the erosion of tax bases and the shifting of profits outside of the EU market.

LD 142/2018 introduced in current legislation certain "anti-BEPS" recommendations, which, to a certain extent, could have also the greatest impact on private equity industry (*e.g.,* how deals are sourced or structured), such as:

- **Art. 1: interest limitation rule** (Art. 4 of ATAD 1);
- **Art. 2 and 3: exit taxation** (Art. 5 of ATAD 1) **and "entry tax"**;
- **Art. 4: controlled foreign company rule** (Art. 7 and 8 of ATAD 1);
- **Art. 5: foreign dividends and capital gains**;
- **Art. 6 to 11: hybrid mismatches** (Art. 9 of ATAD 1, Art. 1 and 2 of ATAD 2).

These changes are **effective from the fiscal year following the one current on 31 December 2018**, with a few exceptions for certain provisions of ATAD 2 entering into force the fiscal years following the ones current on 31 December 2019 and 31 December 2021.

Nevertheless, LD 142/2018 did not implement the measures regarding the General Anti-Avoidance Rule (GAAR), while the Italian legislation in Art. 10-*bis* of Law No. 212 of 27 July 2000 was already considered in line with ATAD 1, which Art. 6 required that "*a Member State shall ignore an arrangement or a series of arrangements which, having been put into place for the main purpose or one of the main purposes of obtaining a tax advantage that defeats the object or purpose of the applicable tax law, are not genuine having regard to all relevant facts and circumstances*".

The following outlines the main changes implemented in the Italian tax system.

2 Interest Limitation Rule

Art. 1 of LD 142/2018 replaced Art. 96 of the Italian Tax Code ("**ITC**") implementing the new interest deduction limitation rules. The objective of this new standard is to discourage groups of companies to reduce their global tax liability through excessive interest payments to both related parties' borrowings and third-parties' borrowings.

The definition of interest given by LD 142/2018 encompasses any taxable item of income or any deductible item of expenses deriving from, or related to, financial transactions or contractual relationships consisting of a significant funding component. Likewise, any interest expenses or income assume relevance for the provision at issue whether, although deriving from financial instruments which are qualified as "instruments representing capital" in accordance with Italian GAAPs or IAS/IFRS, they are fully relevant either as taxable item of income or deductible item of expenses in the hands of the payee and the payer.

In detail, from the first day of the fiscal year following the one that is current on 31 December 2018 (*i.e.* **1 January 2019** for taxpayers whose fiscal year coincides with the calendar year), interest expenses **are deductible up to** an amount equal to the sum of interest income accrued in the fiscal year under consideration and interest income carried-forward from previous fiscal years. Thus, any excess of interest expenses (including interest expenses capitalized on the cost of purchased goods) over the amount of available interest income ("**net interest expenses**") **is deductible up to** the sum of 30% of the gross operating income (EBITDA) of the fiscal year under consideration and 30% EBITDA carried-forward from previous fiscal years. In this regard, the law clarifies that taxpayers should compensate at first instance the 30% EBITDA of the current fiscal year and only at a later stage the 30% EBITDA carried-forward (the **"first-in, first-out" mechanism**).

LD 142/2018 provides also that taxpayers are allowed to carry forward any excess of net interest expenses **without time limitation**, while any excess of unused 30% EIBTDA capacity can be carried forward for a **maximum of 5 years** (the current provision does not provide for a time limitation).

A specific exception is set out for interest expenses related to loans entered into before 17 June 2016 (*i.e.* **"grand-fathering" clause)**, whereby any excess of interest costs carried forward may be deducted against any 30% EBITDA carried forward as calculated under the regime in force until 31 December 2018. In this sense, taxpayers shall declare in their annual Tax Returns whether interest expenses carried-forward were deducted against the 30% EBITDA calculated under the previous regime or the new regime. Such exception should not apply in case of subsequent modifications of the agreement related to the debt instrument (Art. 13(4) of LD 142/2018).

One of the main changes introduced by LD 142/2018 is related to the calculation of the qualifying EBITDA, which is no longer determined on the basis of the relevant items resulting from the company' P&L (*i.e.* "**accounting EBITDA**") but, rather, computed by reference to relevant tax rules contained in the ITC. Hence, the "new" EBITDA is computed adding back to the taxable income "*the tax-adjusted amounts for exceeding borrowing costs as well as the tax-adjusted amounts for depreciation and amortisation*" (*i.e.* "**fiscal EBITDA**").

No changes have been made with reference to the **regime of domestic tax consolidation**. Accordingly, any excess of interest expenses accrued after the inclusion in the consolidation group may be used against any unused 30% EBITDA accrued after the inclusion in the consolidation group by other participants, or to compensate any excess of interest income accrued after the inclusion in the consolidation group by other participants.

Separate rules apply for insurance companies, parent companies of insurance groups, qualifying asset management companies and qualifying brokerage companies: these entities are **not subject to the "EBITDA limitation rule"** and interest expenses can be deducted up to 96% of their amounts.

In conclusion, Italy did not implement certain optional provisions of ATAD 1 (*e.g.* such as the rule according to which net interest expenses could be fully deducted up to 3 EUR/m; or the rule allowing a full deduction for standalone companies) as well as the provision according to which EBITDA and exceeding borrowing costs can be determined at the level of the entity.

What is the impact for the fund industry?

The interest limitation rule may apply to holding or target companies in Italy because of the ultimate investment is made therein. It means that the new law may affect funds structuring strategies including shareholders' loans or financing from third parties to reduce the taxable basis through interest payments.

3 Exit Taxation and "Entry" Tax

Effective from 1 January 2019, the rules about the **transfer of residence** of Italian companies abroad (Art. 166 of the ITC) have been reshaped from a tax perspective, as well as the tax regime applicable in case of **transfer to Italy** of non-resident companies (Art. 166-*bis* of the ITC).

With reference to the exit tax, LD 142/2018 introduced the following main changes:

- the possibility to defer the payment of the exit taxation in case of transfer to another EU member state or an EEA country included in the Italian white list is **repealed**;
- the yearly instalments to pay any gains subject to exit taxation (under certain circumstances) are **reduced** from **6** (six) to **5** (five)***;***
- the **treatment of tax losses** is determined in case of transfer of residence or assets abroad;
- it is clarified that **gains** subject to taxation will be calculated with reference to the **arm's length value** of the transferred assets and liabilities (in place of the "nominal value"), as determined under the relevant transfer pricing rules.

In a nutshell, the new law will cover **transfers abroad** of: i) the residence of Italian entities (unless the assets are entirely allocated to Italian permanent establishments); ii) assets held by Italian entities to permanent establishments under the "branch exemption" regime; iii) Italian permanent establishments of non-resident entities; iv) assets held by Italian permanent establishments of non-resident entities to the head-office or to another foreign permanent establishment; v) cross-border mergers and demergers.

As stated above, ATAD 1 required Italy to **abolish** the current **deferral of exit taxation**: therefore, the only option available to taxpayers (as an alternative to immediate payment) is to pay the exit tax in **equal instalments** (plus interest) over a maximum period of 5 years in case of transfer to another EU member state or an EEA country included in the Italian white list.

Provided that **gains** are determined as difference between the "**market value**" (calculated with reference to the transfer pricing guidelines set by the Ministerial Decree of 14 May 2018) and the value, for tax purposes, of the assets and liabilities of the transferred entity/permanent establishment or of the assets **at the time of exit from Italy**, taxpayers are generally allowed to use **without any limit** the **tax losses carried-forward** in order to offset the taxable income of the last tax period and, to follow, the relevant gains. In contrast, where the taxpayer realizes only a **partial transfer** of assets (*i.e.* part of the assets remains in Italy), tax losses carried-forward can be used to offset **80% of the taxable income** of the last period of residence in Italy (under the ordinary tax rules) while **no limits** would apply to offset the relevant gains.

LD 142/2018 also revised (for systematic consistency with the exit taxation rules) the tax treatment of **inbound transfers of residence**, though not included in ATAD 1. The main change refers to the valuation of assets and liabilities transferred to Italy, calculated with reference to the **transfer pricing guidelines** set by the Ministerial Decree of 14 May 2018. The application of the "**market value**" is therefore provided to replace of the "nominal value" (under the previous law), if the person transferring to Italy is resident in another EU member state or a country with which Italy has an agreement in place for the exchange of information. Where, in contrast, the person transfers from a jurisdiction not included in the said list, the transferred assets and liabilities are recognized at market value insofar as the taxpayer has reached an agreement with the Italian tax authorities under Art. 31-*ter* of the Decree of the President of Republic No. 600 of 29 September 1973 (the "**International Tax Ruling**").

In the absence of such Ruling, the taxpayer must assume the following values to assets and liabilities:

- the tax basis of assets is determined as the **lower** among the acquisition cost, the book value and the market value;
- the tax basis of liabilities is determined as the **higher** among the acquisition cost, the book value and the market value.

What is the impact for the fund industry?

The measure in Art. 166 of the ITC is aimed at granting the taxation rights in Italy in case of businesses or assets being transferred to another jurisdiction. Consequently, it may target fund structures in the "exit" stage. The ATAD package determines a minimum common standard for all EU member states: this means that the new rules should not change investor strategies for the underlying targets or assets.

4 CFC Rule

LD 142/2018 reshapes Art. 167 of the ITC providing that, from 1 January 2019, Italy will tax the non-distributed income of entities qualifying as CFCs if one of the following conditions is met:

- the Italian corporate taxpayer **controls**, either directly or indirectly (also through trustee companies or interposed third persons), **the non-resident company**;
- the Italian controlling corporate taxpayer **is entitled to receive**, either directly or indirectly (also through trustee companies or interposed third persons), **more than 50 % of the profits of the entity**.

The definition of "**control**" relies on Art. 2359 of the Civil Code, whereby a company is deemed to be "controlled" if: i) another company, directly or indirectly, holds the majority of the votes at the shareholders' meeting; ii) another company, directly or indirectly, has sufficient votes to exert a decisive influence in the shareholders' meeting; iii) the company is under the dominant influence of another company by virtue of particular contractual relationship.

The CFC regime applies also to profits derived by Italian **permanent establishments** controlling equity interests in foreign entities. Additionally, ATAD 1 required Italy to extend the scope of application of the CFC provisions to permanent establishments under the **"branch exemption" regime** in Art. 168-*ter* of the ITC (if the permanent establishment meets the CFC test).

The new law provided for the deletion of the categorization between "black-list" CFCs and "white list" CFCs located in jurisdictions that can be deemed to have a low-tax regime. The CFC test is now met if the following conditions find place:

a) the **effective income tax rate** in the foreign jurisdiction is lower than 50% of the Italian corporate income tax that would be applicable to the company if it were resident in Italy; and
b) more than 1/3 of the proceeds of the controlled company derive from **sources of passive income** listed in the following categories:
   1) interest or any other income generated by financial assets,
   2) royalties or any other income generated from intellectual property,
   3) dividends and other income from the disposal of shares,
   4) financial leasing,
   5) insurance, banking and other financial activities,
   6) income from intragroup exchange of goods with low economic added value (or no value),
   7) income from intragroup services with low added value (or no value). The definition of "low added value" services was recalled by the Ministerial Decree of 14 May 2018 implementing measures associated with the application of domestic transfer pricing provisions in Art. 110(7) of the ITC, in line with the OECD standards.

The new rule overrides the **"safe harbour"** rule in Art. 167(5)(a) and (b) of the ITC, which enabled taxpayers to exempt from taxation the income derived by the CFC if it was proved that the entity's core business consisted in an industrial or business activity within the local market, or that, from the participation in the CFC, the Italian controlling company did not achieve the result of shifting income to low-tax jurisdictions. According to the new provision of Art. 167(5) of the ITC, taxpayers may apply for a **tax ruling** (*see* Art. 11(1)(b) of Law No. 212 of 27 July 2000) proving that the CFC entity carries on a **substantive economic activity** in terms of staff, equipment, assets and premises, as evidenced by relevant facts and circumstances.

The attribution of profits to the Italian controlling company shall be made in **proportion** to the participation of the resident shareholder and taxed in the same fiscal period of the controlling company in which the tax year of the CFC ends. The income of the CFC included in the tax base of the Italian corporate taxpayer must be computed as business income, with certain exceptions, and it is subject to a tax rate equal to the **average tax rate** of the tax period under consideration (in any case not lower than the current ordinary corporate tax rate).

In sum, in order **to avoid double taxation** of the CFC income, it is provided that Italy shall allow a deduction from the tax liability of the resident controlling company of the tax paid by the CFC entity, in accordance with the tax credit method in Art. 165 of the ITC. Moreover, where profits distributed by the CFC entity to the resident shareholder have been already included in the taxpayer's taxable income, such amounts are not included in the taxable income up to the amount that has already been taxed under the Italian CFC rules in the hands of the resident shareholder.

What is the impact for the fund industry?

The revised Italian CFC rule is tailored to structures with low taxes entities characterized by the lack of economic substance and which non-distributed profits (irrespective of the country of origin) will immediately become taxable in Italy. This may be an issue in case the fund structure contemplates the use of entities in jurisdictions characterized by certain special tax regimes which may impact their effective tax rate (meeting, therefore, the CFC test).

5 Foreign Dividends and Capital Gains

With reference to foreign dividends and capital gains, LD 142/2018 reviews the general criteria to determine whether the income may be derived from entities located in a low-tax jurisdiction. Before everything else, it is worth noting that the changes have not been required by ATAD 1 in itself, but they are conceived to harmonize these rules with the revised CFC legislation.

As a rule, **foreign dividends** are treated in the same manner as domestic dividends, exempting from taxation 95% of the amounts received by the Italian controlling company (Art. 89(3) of the ITC). However, such exemption does not apply if the foreign company is deemed to be located in a low-tax jurisdiction or can benefit from special regimes that provide, for example, exemptions for foreign income or notional deductions from the taxable base. Under the new rule, an entity is deemed to be resident in a privileged jurisdiction if:

- in case of **control**, the **effective income tax rate** in the foreign jurisdiction is lower than 50% of the Italian corporate income tax that would be applicable to the company if it were resident in Italy;
- in case of **any other equity interest**, the **nominal income tax rate** is lower than 50% of the combined IRES and IRAP standard rates.

However, the resident shareholder **may avoid full taxation** giving evidence that, as from the beginning of the shareholding period, the participation in the foreign entity did not achieve the result of shifting income to low-tax jurisdictions. In this situation, the ordinary 95% exemption from taxation would apply. Instead, if the resident taxpayer is able to prove that the foreign entity predominantly carries on, as its main business purpose, an industrial or business activity (*i.e.* the "substantive economic activity" test), the income received by the foreign entity can benefit from a partial exemption from IRES tax (*i.e.* 50%

of the amount) and the receiving company would be also entitled to an indirect tax credit up to 50% of the underlying corporate tax paid by the foreign entity during the shareholding period.

LD 142/2018 also introduces some changes to the existing provisions applicable to Italian controlling companies in case of **disposal of shares in foreign subsidiaries**. As a rule, Art. 87(1) of the ITC establishes that a 95% exemption from capital gains deriving from the sale of a stake in a non-resident company applies if: a) the Italian selling company had been holding the participation since the first day of the 12th month preceding the disposal; b) the Italian selling company has booked the participation as a fixed financial asset ever since the shares have been held; c) the foreign entity is deemed to be resident in a low-tax jurisdiction; d) the foreign entity carries on a commercial activity.

The main changes refer to the criteria under item c), according to which a foreign entity is deemed to be located in a privileged jurisdiction if:

- in case of disposal of a "controlled" participation, the **effective income rate** is lower than 50% of the Italian corporate income tax that would be applicable had that company be resident in Italy;
- in case of disposal of a "non-controlled" participation, the **nominal income** is lower than 50% of the combined IRES and IRAP standard rates.

However, the resident shareholder **may avoid full taxation** if it gives evidence that, from the beginning of the shareholding period, the participation in the foreign entity did not achieve the result of shifting income to low-tax jurisdictions (newly introduced Art. 47-*bis*(2)(b) of the ITC). If the selling company held the stake for more than 5 years and the foreign entity is not a group affiliate (according to the definition of "control" given for CFC purposes, *see* Art. 167(2) of the ITC), it is sufficient that the safe-harbour requirement **has been met over the previous 5 years**.

Additionally, the condition sub-c) must be met since the beginning of the shareholding period. However, in case of sale of shares held for more than 5 years and not belonging to the same group, it is sufficient that the condition is met continuously for the last **5 years** preceding the date of disposal. Instead, in the case sub-d), the new rule confirms (in line with the previous law) that the requisite of the **commercial activity** still must be met over the previous **3 years only**.

What is the impact for the fund industry?

The new rules tend to clarify the tax treatment of dividends and capital gains derived from low taxed entities. Consequently, fund managers should take a look at their structure (*i.e.* vehicles) to understand whether (sub) holding companies (or other target companies) in Italy may be affected from the aforementioned rules.

6 Hybrid Mismatches

LD 142/2018 implements also the anti-hybrid rules of ATAD 1 and ATAD 2. The new rules shall generally apply from **1 January 2020**, apart from the reverse-hybrid rules (Art. 9 of LD 142/2018) which shall apply from **1 January 2022**. The new provision introduces a complex set of definitions, such as the notions of "hybrid mismatch", "double deduction" or "deduction without inclusion", **aimed at countering the achievement of unintended outcomes in respect of mismatch situations** which could result in undue tax benefits under the laws of the two jurisdictions (*i.e.* double non-taxation). For example, Italy will deny the deduction of expenses related to hybrid arrangements as long as the same expenses are deductible in the EU member state where their source is located ("double deduction") or the corresponding amount of the payment is not taxed in the other EU member state ("deduction without inclusion").

The definitions in LD 142/2018 are generally in line with ATAD 2, with some exceptions (such as for the notion of "taxpayer" which is broader than the definition of "person" in the EU Directive).

Upon implementation of the ATAD package, the taxpayer will have to prove that there is not a hybrid mismatch situation (arrangement or transaction) in order to fully deduct a certain payment in Italy. The Italian tax authorities could require information and proof in this respect, within the ordinary 60 days period given by law.

What is the impact for the fund industry?

This provision may influence fund structures in different ways. For example, it may target certain payments made by a financial instrument involving a deduction without inclusion, which could result in mismatches due to the characterization of the instrument in the investor's jurisdiction. Accordingly, Italy may deny the deduction for tax purposes.

7 Final comment

Overall, Italy opted for most of the ATAD package to remain competitive in the EU. The implementation of ATAD 1 will require managers to focus on the tax consequences for fund structures with a business presence in Italy and to take appropriate actions where necessary. Moreover, even the complexity of the rules introduced with ATAD 2 suggests to reviewing the existing fund structures in order to determine whether, and to what extent, these changes may impact on investments and business activities.