Italy issues draft legislation for major tax reform

Executive summary

On 21 April 2015, the Italian Government issued a set of legislative decrees (Draft Legislation) which significantly reshapes the tax rules applicable to cross-border scenarios and redefines the concepts of abuse of law and tax avoidance. Other meaningful measures include changes to the rules on the statute of limitations in the case of criminal law exposure as well as the introduction of a cooperative compliance program to enhance relationships between taxpayers and tax authorities.

The Draft Legislation represents the first phase of implementation of a major tax reform by the Government in accordance with an empowering law approved by the Parliament on 27 February 2014. (For more information see Global Tax Alert, Italian Parliament passes framework for major tax reform, dated 18 March 2014.) This first set of legislative decrees is mainly focused on simplifying tax rules for international business both with reference to inbound and outbound scenarios as well as to providing certainty and stability of tax rules to attract foreign investments. Additional legislative decrees will be issued in the upcoming months and will address other pillars of the reform.

It is expected that the Draft Legislation should become final shortly with some of the relevant provisions entering into effect as soon as FY 2015.

This document provides an overview of the measures included in the Draft Legislation.

Detailed discussion

Advance tax rulings for companies with international operations

The Draft Legislation expands the scope of a specific type of tax ruling (International Ruling) intended for companies with international operations. The International Ruling is currently available in order to reach agreement with the authorities on transfer pricing issues by concluding advance pricing agreements (APA), cross-border flow matters, the existence of permanent establishments (PE) and the
attribution of profits to domestic and foreign PEs. The International Ruling will also be available to determine asset tax bases in the case of inbound and outbound migrations. The ruling is valid for five years. Nonetheless, under the Draft Legislation, taxpayers will be able to use ruling results (e.g., in the case of an APA) to adjust past years but not beyond the year in which the ruling request was submitted.

**Advance tax ruling for new investments**
A new type of ruling is introduced for investments of at least €30 million and with a positive and long lasting impact on employment. The scope of the ruling encompasses the entire investment plan and includes significant tax aspects such as an assurance on the absence of abusive behaviors, the confirmation of prerequisites to access specific tax regimes and the correct treatment of any mergers and acquisitions. Taxpayers conforming to the ruling response may also take advantage of the cooperative compliance program (see below), irrespective of their turnover.

**Dividends from black list countries**
Current rules provide that dividends paid by black list companies held directly or indirectly by Italian recipients are fully subject to tax (i.e., do not benefit from the ordinary dividend exemption regime), unless a specific ruling is obtained. The Draft Legislation confirms full taxation of black list dividends in the case of direct participation while, with reference to indirect participations, full taxation will only apply if the underline black list participations are held through white list companies controlled by the Italian parent.

Italian companies subject to full taxation on dividends and capital gains related to black list subsidiaries will be able to benefit from an underlying foreign tax credit for any taxes paid by the relevant black list entities.

**Interest expense deduction**
Dividends received from foreign controlled subsidiaries will be included in the earnings before interest, tax, depreciation, and amortization (EBITDA) of Italian companies for the purposes of computing the 30% EBITDA cap to net interest expense deduction. As a counterbalance, Italian groups can no longer avail themselves of foreign entities’ EBITDA, currently allowed under certain circumstances.

The new rule should apply as of the tax period following the one of its publication in the Official Gazette, i.e., presumably as of FY 2016.

**Black list costs and fair market value**
Current rules prevent the deduction of costs incurred for the purchase of goods and services from black listed entities (e.g., Swiss and Hong Kong companies) unless proof is provided about the business substance of the black list company (First Exemption) or about the economic interest of the purchaser in entering the transaction and its actual execution (Second Exemption).

The Draft Legislation repeals the First Exemption and includes a safe harbor for the deduction of black list costs up to the limit of the fair market value of the executed transaction. The deduction of any exceeding value will be subject to the Second Exemption test (i.e., proof that the transaction at stake responds to an actual business interest and that the transaction has been actually carried out).

**Horizontal consolidation**
In line with Case C-40/13 of the Court of Justice of the European Union, the draft legislation introduces explicit language on the possibility to elect for a domestic tax consolidation between two or more Italian sister companies with a common parent residing in any European Union (EU) or qualifying European Economic Area (EEA) countries (horizontal consolidation). The horizontal consolidation will also include Italian PEs of qualifying EU and EEA group entities.

**Italian PEs of foreign entities**
The draft legislation introduces language concerning the attribution of income to Italian PEs in line with the “Authorized Organisation for Economic Co-operation and Development (OECD) Approach.” Dealings between Italian PEs and foreign headquarters will therefore be explicitly subject to Italian transfer pricing rules. Accordingly, the draft legislation also removes those Italian provisions providing for PE force of attraction. Methods to quantify the endowment fund of a PE will be clarified by an upcoming regulation.
Foreign PE of Italian entities
As an exception to the standard foreign tax credit rule, the draft legislation introduces an election to exempt the income generated through foreign PEs which are not located in black list countries. The election is irrevocable and involves automatically all of a company’s PEs (i.e., “all in - all out”). Recapture rules apply with respect of any tax loss derived through the PEs in the years prior to the election.

Controlled foreign companies (CFC)
The ruling procedure to avoid CFC legislation consequences is no longer mandatory. The conditions required for the exemption from the regime can now be proved during the tax audit phase. Furthermore, CFC rules will be applicable only to controlled companies as opposed to the current legislation which applies also to qualifying minor shareholdings.

Outbound migration
The elective migration regime based on tax deferral also will be made explicitly available to the transfer of Italian PEs (or of a branch of business related thereto) of a foreign company to any EU member state or any qualifying EEA country. The deferral regime will also apply in the case of cross border mergers and other reorganizations where no PE is left behind in the Italian territory.

Inbound migration
The transfer of tax residence into Italy of foreign white list companies will entail the tax step up of all the assets and liabilities at fair market value. Unless an International Ruling is obtained, in the case of migration from a black list jurisdiction, the tax basis of the assets will be considered equal to the lower between the acquisition cost, the accounting value or the fair market value, while the tax basis of the liabilities will be equal to the higher.

Shareholder debt waiver
In the case of shareholder debt waiver, the Italian debtor will be taxed on the portion of the waiver exceeding the tax basis of the receivable at the level of the shareholder, irrespective of the relevant accounting treatment. The deduction of bad debt losses will be recognized also with reference to foreign insolvency procedures similar to the Italian ones.

Foreign tax credit
Beneficial rules on foreign tax credit currently reserved to foreign PE income and certain foreign business income are extended to any other category of income generated abroad. Such rules concern (i) an immediate recognition of the credit (i.e., in the tax return related to the year in which the foreign income is subject to tax in Italy) even if the foreign tax is not definitively paid yet, provided it will become so by the time of the filing of the tax return related to the following tax period and (ii) the possibility to carry back and carry forward any excess of foreign tax.

Abuse of law
The draft legislation repeals the general anti-avoidance rule (GAAR). It introduces a written definition of “Abuse of Law” which replaces any previous case law and interpretations which were based on an unwritten principle. The new provision clarifies that any abusive conduct does not trigger criminal liability exposure.

Statute of limitations and criminal law violations
Current rules provide that the ordinary statutes of limitations are extended by double in all cases where it is mandatory for the tax authorities to report a tax violation to the criminal law prosecutor. The Draft Legislation restricts the cases in which the statute of limitations may be doubled. The extension will not be allowed if a criminal notice is issued by the tax authorities once the ordinary terms have already elapsed.

Cooperative compliance program
An elective cooperative compliance program is introduced in favor of taxpayers that adopt an adequate internal audit model to manage and control their tax risk. By adhering to the regime, taxpayers will be able to agree on tax positions with the authorities before the filing of the return, obtain quicker rulings and avoid providing guarantees for tax refunds. The program is initially devoted to large taxpayers (i.e., with a turnover of at least €10 billion and those who took part to the relevant pilot project with a turnover of at least €1 billion) but will be subsequently extended to smaller businesses.
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