Executive summary

On 8 August 2018, the Italian Government issued a draft Legislative Decree (the Decree) for the transposition of European Union (EU) Directive n. 1164/2016 also known as the EU Anti-Tax Avoidance Directive (ATAD) as amended by EU Directive n. 952/2017 (ATAD 2), together with a draft explanatory report (the Report).

The Decree contains new legislative language with reference to the following areas:

1. Deduction of interest expenses
2. Exit taxation
3. Controlled Foreign Corporations (CFCs)
4. Dividends and capital gains associated with foreign subsidiaries
5. Hybrid mismatches

No changes have been introduced with reference to the General Anti-Avoidance Rule (GAAR) as Italy’s current legislation is considered already in line with the ATAD.¹
The new set of provisions are expected to be officially released by the end of 2018. Once released, they should enter into force for calendar year companies as of 1 January 2019, with the exception of hybrid mismatch rules that should apply from 1 January 2020, and with specific reference to reverse hybrids from 1 January 2022.

This Alert summarizes key provisions of the Decree. Future Alerts will report on any changes to the provisions prior to official release or after its entry into force.

Detailed discussion

**Deduction of interest expenses**

The Decree replaces Article 96 of the Italian Tax Code (ITC) regarding interest expense deduction rules. The new language rephrases the existing 30% earnings before interest, taxes, depreciation and amortization (EBITDA) limitation rule with some changes.

In short, interest expenses can be deducted for an amount corresponding to the total of annual interest income plus any excess interest income from prior fiscal years (FYs), with any excess being deductible within the limit of the current FY 30% EBITDA plus any 30% EBITDA carried forward from previous FYs. The rule also applies at the level of a domestic tax group, meaning that group members may surrender excess interest expenses, excess interest income and excess 30% EBITDA to the fiscal unity.

The €3 million minimum deduction allowed by the ATAD has not been included and there is no reference to escape clauses for taxpayers that are part of a consolidated group for financial accounting purposes. Separate rules apply for financial and insurance companies.

**Main changes with reference to the old provision**

- Qualifying EBITDA is no longer based on accounting figures as it should now be computed on the basis of corporate income tax (CIT) relevant values. Among other things, items of income that are exempt from taxation (e.g., income qualifying for the Patent Box regime) should be excluded from the 30% EBITDA computation. Notional Interest Deduction (NID) should not have any impact as it has no specific link with any EBITDA item.
- Interest expenses capitalized on the cost of purchased goods are now included.
- Interest income in excess of interest expenses of a given FY can now be carried forward to offset interest expenses in any following FYs. This mechanic is not explicitly provided by the ATAD but the Report considers it compatible with the goals pursued by the latter.
- Excess 30% EBITDA can be carried forward for five FYs (while there was no limitation under the old rule).
- An ordering rule is introduced where net interest expenses should first be deducted against the annual 30% EBITDA and then against excess 30% EBITDA from previous FYs (by prioritizing the amounts accrued in the less recent FYs).
- The definition of interest and other financial payments qualifying for the 30% EBITDA rule has been revised with more focus on the financial cause of contractual relationships (substance over form).
- Special rules apply to enterprises dealing with the Public Administration.

**Grandfathering clauses**

Grandfathering provisions allow any excess interest expenses accrued under the old regime to be carried forward. They also allow excess 30% EBITDA computed under the old rules be used to deduct excess interest expenses accrued on financial arrangements made before 17 June 2016 (companies may elect whether prioritizing the use of excess previous 30% EBITDA vs. the annual 30% EBITDA computed with the new rules).

**Exit taxation**

The new rule reiterates the current exit taxation provision (Article 166 ITC) with some exceptions.

**Main changes with reference to the old provision**

- The scope of the provision is now explicitly broadened from straight tax residence migrations and cross-border mergers to other cases such as demergers, transfers of assets to foreign (exempted) permanent establishments (PE), or from an Italian PE to its foreign headquarters.
- The new provision no longer allows the deferral of capital gain taxation on migrations to EU or European Economic Area jurisdictions. The only possibility left to mitigate the impact of the deemed realization is the election for five annual installments (vs. the previous six-year installment clause).
• It is explicitly provided that any tax loss carried forward can be used beyond the limit of the 80% profit offset limitation to the extent that no PE remains in the Italian territory.

Inbound migrations
The new rule reiterates the current provision (Article 166-bis ITC). It provides that: (i) the tax basis of the assets migrating to Italy will correspond to their Fair Market Value (FMV) as long as the departure jurisdictions are white listed, while (ii) if the departure jurisdictions are not white-listed, an advanced ruling is needed (otherwise, the tax basis of the incoming assets will reflect the lower amount between purchase price, accounting value and FMV, and the tax basis of the incoming liabilities will correspond to the higher amount between the said elements).

Main changes with reference to the old provision
The new provision explicitly broadens its scope. The outbound cases covered by the above mentioned exit tax provision are here covered under an inbound perspective (e.g., company migrations, transfer of a company’s assets to its Italian PE, foreign entity merging into an Italian company).

Foreign controlled corporations (CFCs)
The new rule mainly restates the old one (Article 167 ITC) by confirming that the income generated by CFCs residing in low tax jurisdictions is taxed at the level of the Italian parent, unless certain exceptions apply.4

Main changes with reference to the old provision
• The new rule slightly redefines the concept of “control” by reference to two alternative criteria:
  − Direct or indirect control exercised, also by way of trust companies or intermediaries, through the majority of voting rights or a qualifying influence in a foreign company’s shareholders meeting under Article 2359 of the Italian Civil Code (ICC).
  − Over 50% of the participation in a foreign company’s profits is held either directly or indirectly by way of other companies controlled under Article 2359 ICC, also by way of trust companies or intermediaries.

• The old provision provided for two different parameters to qualify a CFC as low taxed: one for companies located in white list jurisdictions (including the EU), if subject to less than 50% of the Italian effective tax rate while deriving more than 50% passive income, and another for non-white list companies, if subject to less than 50% of the nominal Italian rate also by way of special regimes. The new version of the rule revisits and unifies the above criteria by qualifying a company, irrespective of being white listed or not, as a low taxed CFC if:
  − It is subject to an effective tax rate lower than 50% of the effective burden that would have suffered had it been an Italian resident, and
  − It has more than 1/3 of passive income (i.e., dividends, interest, royalties) by also including financial lease income, assurance, bank and other financial activities, as well as income derived from sales of goods or provision of low-value services to related parties.

• An exemption from such CFC rules is available to companies proving that an actual business is carried out in the foreign jurisdiction by way of local personnel, equipment, other assets and premises (the old rule also provided for an alternative exemption based on proving an ultimate adequate level of taxation).

Dividends and capital gains
The Decree also introduces some changes to the rules applicable to Italian companies deriving foreign dividends and capital gains from the disposal of foreign subsidiaries.

As a rule, the main tax treatment criteria have been confirmed. Therefore, such dividends and capital gains are generally 95% excluded from Italian corporate taxation unless derived from low tax jurisdictions (or, in the case of capital gains, missing other specific conditions).5 However, dividends may benefit from a 50% exclusion (and from an underlying foreign tax credit in the case of a controlling participation) by proving that an actual business is carried out in the foreign jurisdiction by way of local personnel, equipment, other assets and premises (Exception 1), or from the standard 95% exclusion by proving that an ultimate adequate level of taxation was borne by the foreign subsidiary (Exception 2). Capital gains are fully taxable even under Exception 1 (but an underlying foreign tax credit is recognized in the case of a controlling participation), while they may still benefit from the standard 95% exclusion under Exception 2.

Main changes with reference to the old provision
• The criteria to define whether a foreign subsidiary is located in a “low-tax jurisdiction” (with the consequence of disallowing the 95% participation exemption regime on dividends and capital gains) is aligned with the criteria applicable for the new CFC rules (see above), i.e., effective level of taxation lower than 50% of the Italian one. However,
in the case of foreign subsidiaries that are not controlled by the Italian parent (e.g., less than 50% participation), a simplified criterion will apply based on the nominal tax rate lower than 50% of the Italian nominal CIT rate or on local special tax regimes leading to the same result.

Also, the 95% participation exemption regime is now allowed on capital gains derived from substantial participations in low-taxed subsidiaries provided that they are listed on a stock exchange (as already provided for in the case of gains from non-substantial participations, as well as for dividends).

New rules on hybrid mismatches

The Decree (Articles 6-10) introduces new rules aimed at contrasting the phenomena of “double deduction” and “deduction without inclusion” derived from conflicts in the qualification of certain arrangements or transactions between one or more tax jurisdictions.

Income mismatches derived from different valuation rules applied by tax systems, also as a consequence of transfer pricing, should not give rise to hybrid mismatches. Similarly, benefits derived from the Italian NID regime, and similar provisions, should not fall in the scope of these rules since they are not associated with a financial flow.

The provisions react by disallowing payment deductions unless it is proven that the tax inclusion occurred in the other relevant jurisdictions. As a principle, taxpayers can claim back their deduction by proving that foreign taxation occurred at a later stage or, in certain circumstances, can exempt a portion of income for an amount equal to the formerly disallowed deduction.

Types of hybrid mismatches

The Decree addresses the following definitions of hybrid mismatches (Article 6, paragraph 1, letter r):

- **Hybrid instruments**, e.g., where a financial instrument is qualified as a debt instrument in the country of the payer (with a tax deduction being recognized), while it is seen as an equity instrument in the country of the beneficiary (with dividends being exempt).

- **Hybrid transfers**, e.g., where a repurchase agreement is seen by the jurisdiction of the first seller (borrower) as a loan collateralized by some company shares transferred temporarily to the second seller (lender), by so treating the attribution of dividends to the latter as deductible interest expenses for the borrower, while the lender’s jurisdiction sees a temporary purchase of shares (formalistic approach) and recognizes a dividend exemption.

- **Payments in favor of hybrid entities**, e.g., where a deduction is recognized for a payment in favor of an entity treated as transparent in its country of formation (no inclusion), while treated as opaque by the jurisdictions of the shareholder (no inclusion).

- **Payments in favor of a company with one or more PEs**, e.g., where a deduction is recognized for the payer but no inclusion is recognized in the jurisdiction where the recipient is located because of a mismatch in the profit attribution rules between the country of the headquarters (HQ) and that of the PE, or between the countries of two or more PEs of the same company.

- **Payment in favor of a disregarded PE**, e.g., where a deduction is recognized for the payer but no inclusion is recognized at the recipient level since the HQ jurisdiction attributes the income to a PE (under an exemption regime) and the jurisdiction of the PE does not recognize its existence. In this respect, the Report recommends that if Italy is the HQ jurisdiction, the PE exemption should be revoked in favor of a foreign tax credit.

- **Payments made by hybrid entities**, e.g., where a company, seen as opaque by its jurisdiction, and that is part of a domestic tax group, makes a deductible interest payment to the shareholder whose residence jurisdiction treats the company as transparent (no inclusion of interest income).

- **Payments between HQ-PE or between PEs of a same company**, e.g., where a deduction without inclusion may occur to the extent that the relevant income is not recognized as such under the rules of the country of the beneficiary.

For all of the above categories of arrangements, the Decree specifies that no actual mismatch occurs if a double deduction or a deduction without inclusion would have, in any case, taken place because of an exempt status of the recipient on the basis of the tax rules of its jurisdiction of residence or location.

Imported mismatches

Article 8, paragraph 3, of the Decree addresses the case where any of the above hybrid arrangements take place out of the Italian jurisdiction with the hybrid result been indirectly “imported” into Italy. This happens by having an Italian entity making a deductible non-hybrid payment to a foreign party which is part of a hybrid arrangement involving other jurisdictions, with the ultimate consequence that the proceeds paid by the Italian company are not subject to tax.
should not occur in Italy since, based on the current rules, Italy would always tax the income in the hands of the foreign shareholders.

Reverse hybrids
Article 9 of the Decree addresses the case of a reverse hybrid entity formed in the Italian jurisdiction, i.e., treated as tax transparent in Italy and as an opaque entity by the foreign jurisdiction where the shareholders are located. The rule is designed to avoid that items of income derived by the Italian entity are disregarded in Italy (by being attributed to the foreign shareholders), while (absent a formal distribution by the Italian company) they are not subject to tax in the foreign jurisdiction. The Report observes that such consequence should not occur in Italy since, based on the current rules, Italy would always tax the income in the hands of the foreign shareholders.

Dual residence mismatches
Article 10 of the Decree addresses the case of a negative item of income borne by an Italian resident company who is also resident of another EU or third country. The rule provides that the deduction is disallowed to the extent that the same expense is deductible in the other jurisdiction. However, should the same taxpayer derive in the following years an item of income which is subject to double taxation, an income exclusion will be recognized up to the amount to the previously disallowed deduction.

Endnotes
For additional information with respect to this Alert, please contact the following:

**Studio Legale Tributario, International Tax Services, Milan**
- Simone De Giovanni  simone.de-giovanni@it.ey.com
- Marco Magenta  marco.magenta@it.ey.com
- Maricla Pennesi  maricla.pennesi@it.ey.com

**Studio Legale Tributario, International Tax Services, Roma**
- Daniele Ascoli  daniele.ascoli@it.ey.com

**Studio Legale Tributario, International Tax Services, Bologna**
- Mario Ferrol  mario.ferrol@it.ey.com

**Ernst & Young LLP (United Kingdom), Italian Tax Desk, London**
- Domenico Borzumato  dborzumato@uk.ey.com

**Ernst & Young LLP, Italian Tax Desk, New York**
- Emiliano Zanotti  emiliano.zanotti2@ey.com
- Fabrizio Iachini  fabrizio.iachini1@ey.com
- Daiana Buono  daiana.buono1@ey.com
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