Italy issues guidance on participation exemption rules

On 29 March 2013, nine years following the introduction of the participation exemption on capital gains, the Italian Revenue Agency (IRA) issued its second guidance on this regime via Circular letter 7/2013 (the Circular). An overview of the key clarifications follows.

Background

Article 87 of the Italian tax code (ITC), provides that 95 percent of the amount of capital gains derived from the disposal of shares and other participations by Italian resident companies is exempt from corporate income tax (IRES), provided that:

- The participation has been held continuously from the first day of the 12th month prior to the disposal (Minimum Holding Period test);
- The participation has been booked as a long-term investment in the first balance sheet closed during the ownership period (Balance Sheet test);
- The participated entity has been a resident of a white list country during the three financial years preceding the year of the disposal (White List test); and
- The participated entity has been performing an actual business activity during the three financial years preceding the year of the disposal (Active Business test).

With reference to the prerequisites under the White List test and the Active Business test, if the held entity was acquired less than three years (but at least 12 months) before its disposal by the relevant taxpayer, the tests need to be verified by aggregating the period when the participation was in the hands of the previous owner/s. If the held entity was incorporated less than three years before its disposal, the two tests must be met starting from the day of incorporation.
Specific rules apply to real estate and holding companies.4

New clarifications
The Circular provides various clarifications on the relevant regime by focusing, among other things, on the Active Business test and the application of the rule in the case of disposal of foreign holdings.

**Active Business test**
The Active Business prerequisite has been a theme of debate since the introduction of the participation exemption regime.5

With the Circular, the authorities clarify that the Active Business test is generally met if the held company is equipped with an operational structure suitable for the carrying out of a manufacturing and/or sales activity with respect to goods or services which may potentially generate revenue. The guidance mentions that this entails the need that the assets of the held company form a going concern.

In this respect, it is specified that an Active Business is meant to exist also when an enterprise has the ability, even if only potentially, to meet the market demand in a time frame reasonably expected in relation to the specific industry.

The authorities also confirm that an Active Business is generally missing when a company is involved in the “mere passive management” of assets from which passive income is derived.6

Moreover, the authorities state that whenever a company is engaged in both passive and active businesses, a case by case valuation is to be made to identify which of the two is predominant.7

**Active Business test and start-up activities**
The IRA explains that start-up activities may count as Active Business provided that, after completion of the relevant preparatory and auxiliary fulfillments, the entity is in fact able to carry out its core business activity. This means that, under certain conditions, the time accrued during the start-up phase may retroactively qualify for the computation of the three year Active Business test required as one of the conditions to benefit from the participation exemption regime (i.e., the start of the real business activity causes a “carry-back” of the Active Business to the start-up years).

The guidance also mentions that, under specific circumstances, start-up activities may directly qualify as Active Business without the need to wait for the business capacity to become real (i.e., with no need to wait for an event which triggers the “carry back” effect).

For instance, in the case of qualifying construction projects to be operated under public concessions, the preliminary stages of planning and construction can be already deemed as actual business because the mentioned activities are part of the business purpose of the enterprise. Therefore, the preliminary activities will qualify as Active Business even before the completion of the project, the authorities say.

Similarly, certain preliminary analysis and fulfillments carried out by energy companies engaged in qualifying construction activities also represent an Active Business. The guidance makes the example of activities aimed at finding the suitable site to locate energy plants, obtaining relevant permits and approvals as well as the related design and the construction work.

**Holding Companies**
Article 87(5) of the ITC provides that if an Italian company holds a participation in a holding company, the Active Business and White List tests are to be verified at the level of the holding company’s subsidiaries (“look through” approach). In particular, the two tests are deemed to be satisfied if they are met by the subsidiaries that represent the majority of the assets of the said holding company.

In this respect, the guidance clarifies some procedural aspects related to the case of an Italian company selling a participation in (1) a black list sub-holding with participations in white list subsidiaries and (2) a white list sub-holding with participations in black list subsidiaries.

In the first case, the authorities confirm that the taxpayer is first required to file an advance ruling clearance proving that the participation in the black list sub-holding does not result in the allocation of income to black list countries (i.e., by superseding the White List test at the sub-holding level).8 Then, it should demonstrate under the mentioned look-through
approach, that the underlying white list entities meet the Active Business requirement.

In the second case, the guidance specifies that the taxpayer should look through the white list sub-holding altogether by proving the Active Business and the White List test directly at the level of the underlying black list subsidiaries.\(^9\)

**Additional clarifications**

The IRA also provides for other clarifications including the following:

- The White List test has to be met not only for the three year period before the disposal, but also since the beginning of the ownership by the relevant taxpayer. In this respect, it is clarified that even if an Italian company has a black list subsidiary that migrates to a white list country, the subsequent disposal of the participation cannot benefit from the participation exemption regime even after three years of white list residence (unless a ruling is obtained as in any other case concerning a black list subsidiary).

- Pledging the participations for the purpose of securing debt should not count as an interruption of the holding period at the level of the Italian shareholder, as well as any other way of utilizing the participations for guarantee purposes. An interruption will only occur if the borrower fails to meet its obligations and the ownership over the participations is actually transferred to the lender.

- The transfer of participations under a repo transaction should not interrupt the shareholding period.

- In case portions of participations in a company were purchased on different dates, the guidance confirms that a Last In First Out (LIFO) method applies to compute the shareholding period. It is clarified that the same method applies if participations in a company are in part booked as long-term investments and in part as current assets, and before the sale of such participations some are transferred from one category to the other (specific rules may apply for IAS/IFRS adopters).
Endnotes

1. The regime was introduced as of 1 January 2004. IRA issued its initial guidance via Circular letter n. 36/2004.

2. The participation exemption regime can even apply in the case of black list entities provided that a specific ruling clearance is obtained from the IRA. The Ruling must prove that the participation does not result in localizing the income in low tax jurisdictions. In practice, the taxpayer should prove that more than 75 percent of the income is subject to tax in white list countries. Interrelations with CFC rules may come into play under this scenario.

3. This requirement is not relevant in the case of participations in companies listed in a regulated stock exchange.

4. Article 87 specifically excludes the existence of an Active Business in the case of real estate companies (i.e., companies whose assets are predominantly represented by properties other than those built and/or sold by such company or those instrumental to the carrying out of a business activity). As to holding companies, see Holding Companies paragraph in Alert.

5. E.g., the IRA issued negative rulings concerning the case of a real estate rental activity (152/2004), the lease of the whole going concern (163/2005) and the management of payables and receivables (165/2005).

6. Explicit reference is made to Revenue Ruling 226/2009 concerning a Dutch subsidiary engaged in the management of a trademark. In such occasion, the authorities expressed the principle that the mere management of an IP does not represent an Active Business and therefore cannot benefit from the participation exemption regime. One may wonder whether and to what extent a company that “actively” manages an IP could amount to an Active Business. While there seems to be no clear answer, both Ruling 226/2009 and Circular letter 7/2013 refer to the need of a case by case analysis based on the facts.

7. For instance, the guidance recalls a case where a business consisting in the lease of the whole going concern was considered passive and, accordingly, the participation exemption was denied. The guidance goes on and says that in the case of a company that leases out only part of its going concern, a valuation should be made to verify whether the passive or active sides of the business prevails.

8. As mentioned in Endnote 2, the taxpayer should prove that more than 75 percent of the income earned by the black list company is subject to tax in white list countries.

9. The White List test must be superseded by way of a tax ruling as described in the Alert.
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