Italy implements the ATA Directives in its legal system

On 28 December 2018, Legislative Decree No. 142 of 29 November 2018 (the "Decree") implementing Council Directives (EU) 2016/1164 and 2017/952 (the Anti-Tax Avoidance Directives; "ATAD") was published in the Italian official gazette. The Decree:

i. significantly changes the Italian interest barrier rule, the exit and entry taxation rules, thae controlled foreign companies ("CFC") legislation, and the tax regime applicable to foreign dividends and capital gains (effective as of 1 January 2019);
ii. enacts a completely new set of rules targeting hybrid mismatches (effective as of 1 January 2020, except for reverse hybrids rules);
iii. introduces, effective as of 2018, the new definitions of financial intermediaries, financial holding companies and non-financial holding companies, which are relevant for corporate income tax (IRES) and regional tax (IRAP) purposes (e.g. a 3.5% IRES surtax and higher IRAP rates apply to financial intermediaries and financial holding companies).

Interest barrier rule

The Decree amends the existing interest barrier rule under Article 96 of Presidential Decree No. 917 of 22 December 1986 ("Income tax code", or "ITC") to make it consistent with ATAD. The most significant changes are as follows:

i. Net interest expenses are currently deductible up to 30% of the accounting EBITDA. The accounting EBITDA will be replaced with an EBITDA based on the tax P&L (Tax EBITDA). The Decree provides for certain interim rules to handle the switch from accounting EBITDA to tax EBITDA.
ii. Under current law, if 30% of the EBITDA of a tax year is greater than the amount of net interest expenses, the excess can be carried forward without any time limitation. The Decree introduces a 5-year limitation to this carry forward. Any excess EBITDA still available at the end of tax year 2018 may be carried forward without any time limitation but only to deduct interest expenses accrued on financings entered into before 17 June 2016.
iii. The interest limitation rule will be extended also to (a) interest capitalized in the cost of assets (including inventory), (b) interest accruing on trade payables, (c) interest incurred by real estate companies on mortgage loans (this extension, however, is put on hold by Article 1(7) of Law No. 145 of 30 December 2018 until the future reform of the tax regime applicable to real estate companies; therefore, this interest is currently still outside the scope of the interest limitation rule) and (d) bond issuance costs that are deducted on a cash basis. All these expenses currently fall outside the scope of application of the interest barrier rule.

Exit/entry taxation rules
The Decree modifies the Italian exit tax regime under Article 166 ITC as follows:

i. Built-in gains subject to exit taxation will be determined based on the deemed sale of the transferred assets and liabilities at their arm's length value for transfer pricing purposes.
ii. Under current rules, taxpayers can elect to defer the payment of the exit tax or to pay it in six equal yearly instalments. The option to defer payment of the exit tax is repealed and the yearly instalment payments are reduced from six to five.
iii. Revised Article 166 ITC also clarifies the rules applicable to carry forward tax losses in cases of outbound transfers.

In the case of inbound transfers, new Article 166-*bis* ITC (as revised by the Decree) provides that the tax basis of assets and liabilities transferred to Italy must be determined according to transfer pricing rules. This rule applies to any inbound transfer from a country, whether within the EU or not, that effectively exchanges information with Italy. If the inbound transfer is from a jurisdiction that does not effectively exchange information with Italy, the tax basis of the imported assets and liabilities is their market value only insofar as the taxpayer and the Italian Revenue Agency have concluded a unilateral advance pricing agreement; absent such an agreement, the tax basis of the imported assets (and liabilities) is the lower (the higher, for liabilities) of (a) their acquisition cost, (b) their book value and (c) their arm's length value.

CFC rules
The Decree reshapes and simplifies the Italian CFC rules under Article 167 ITC. Current Italian CFC rules apply to Italian resident persons (including individuals) that control non-resident entities if these entities meet the CFC test and no safe harbour applies. The Decree affects the following key elements of Italian CFC rules:

i. Scope of application: CFC rules will apply also to Italian permanent establishments (PE) of non-resident persons if the PE effectively holds controlling equity interests in foreign entities.
ii. Control: The notion of control is broadened. Under current rules, control is defined by reference to the legal concept of control under Article 2359 of the Italian Civil Code. This requires that the Italian resident person be in a position to exercise a definite influence, via voting rights or even contractual relationships, over the decisions of the foreign entity. Under the new rules, an Italian resident person (or an Italian PE) will be deemed to control the foreign entity also if it holds, directly or indirectly, more than 50% of the profit participation rights in the foreign entity.
iii. CFC test: Under the new rules, a controlled foreign entity is a CFC if two conditions are met:
    a. The foreign entity's effective tax rate is lower than 50% of the effective tax rate that would apply if that entity were a tax resident of Italy; and
    b. More than one third of the revenues realized by the foreign entity are "tainted", i.e. interest, dividend, royalties, capital gains on shares and revenues from financial leasing; revenues from insurance, banking and other financial activities; revenues from trading goods that are purchased from or sold to associated enterprises, with the addition of no or little economic value; and revenues from supplying services that are purchased from or provided to associated enterprises, with the addition of no or little economic value. Whether the foreign entity sells goods or supplies services with little or no added value is determined based on transfer pricing regulations.
iv. Safe harbour: Even if the non-resident entity meets the CFC test, the CFC regime does not apply if the CFC carries on a substantive economic activity supported by staff, equipment, assets and premises.

If the two-pronged test is met and the safe harbour does not apply, the entire income of the CFC (and not just the tainted income) is attributed pro rata (based on profit participation) to the Italian controlling person. The CFC's income is computed based on Italian corporate tax rules and is ring-fenced from the other income of the Italian person and therefore taxed separately with no possibility to utilize tax losses, other than those of the CFC.

Tax regime of foreign dividends and capital gains

Under domestic law, Italian resident enterprises (whether corporate or individual) may benefit from dividend and participation exemption regimes. However, such exemptions are not applicable on foreign-sourced dividends and capital gains if the non-resident company that distributes the dividends (or that is sold) benefits from a low-tax regime. Italian resident individuals who do not hold the shares for the purpose of their business activity must fully include these "low-tax" dividends and capital gains in their tax base subject to progressive personal income tax rates (instead taxing them by applying a 26% substitute tax). This full taxation regime has some exceptions.

The Decree changes the criteria to identify whether a foreign tax regime is "low-tax". Two different criteria apply depending on whether the Italian shareholder controls the non-resident entity. Control is defined according to CFC rules (as revised).

i. Controlled entities: A foreign regime is deemed to be a low-tax regime if the foreign entity's effective tax rate is lower than 50% of the effective tax rate that would apply if that entity were a tax resident of Italy.
ii. Other entities: A foreign regime is deemed to be a low-tax regime if the nominal foreign tax rate (as established by also taking into account special tax regimes) is lower than 50% of the nominal Italian tax rate.

As under current law, tax regimes available in other EU or EEA States are not considered low-tax regimes for these purposes.

Moreover, the Decree partly amends the exceptions to the full taxation regime described above. In particular:

1. Dividends distributed by controlled foreign entities are exempt in Italy up to the amount of profits that have already been taxed in Italy under the CFC rules; a similar result is achieved, in respect of capital gains on the shares of the controlled foreign entities, by increasing the tax basis of those shares by the amount of profits that have already been taxed in Italy under the CFC rules.
2. Dividends from "low-tax" entities (and capital gains realized upon sale of these entities) enjoy the same tax regime as domestic dividends (and capital gains) if taxpayers can prove that the investment in the foreign entity did not achieve the result of shifting income to low-tax jurisdictions. For capital gains, taxpayers must give evidence that this condition is met (i) in the 5-year period before the sale if the buyer is a third party and (ii) for the taxpayer's entire holding period if the buyer is a related person.
3. If the exception under "2" above does not apply and the "low-tax" entity carries on a substantive economic activity supported by staff, equipment, assets and premises, (i) only 50% of the dividends distributed to Italian resident companies (as well as to other business entities and Italian permanent establishments of non-resident entities) are included in the corporate tax base and (ii) an indirect tax credit is granted to the controlling shareholder (whether corporate or individual) for income taxes levied on the foreign entity's profits. Corporate taxpayers may combine the 50% exemption and the pro-rated (50%) indirect tax credit. The indirect tax credit may apply also in cases of capital gains, whereas the 50% exemption does not.

Hybrid mismatches rules

The Decree implements the ATAD anti-hybrid provisions, with a wording that is, in many cases, almost identical to that of the Directives. However, there are some notable departures, such as, for instance, the notion of taxpayer, which is broader than in the ATAD and covers also business partnerships (fiscally transparent under Italian law) and individual entrepreneurs.

The Decree mandates special procedures for auditing and assessing hybrid mismatches. Tax authorities must send a preliminary information request to taxpayers describing the alleged violations and taxpayers have 60 days to reply.

The new anti-hybrid rules apply to tax years starting on or after 1 January 2020, except for the reverse-hybrids rules, which apply to tax years starting on or after 1 January 2022.

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