MAISTO E ASSOCIATI

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The Italian Supreme Court rules that the participation exemption regime breaches EU law

With decision No. 21261 of 19 July 2023, the Italian Supreme Court ("**Supreme Court**") acknowledges that the Italian participation exemption ("**Pex**") regime entails a discriminatory treatment against French resident companies in the light of the EU fundamental freedoms and that its application (currently available only to Italian resident companies or permanent establishments located in Italy) should therefore be extended also to the former, if the relevant conditions are met. The Pex regime provides, subject to certain requirements, for a 95% exemption on capital gains arising on the disposal of participations.

The case dealt by the Supreme Court concerned a French tax resident company with no permanent establishment in Italy ("**FrenchCo**"), which, in 2013, sold its participation in an Italian resident company ("**ItaCo**"). This participation qualified as "substantial" (*importante*) within the meaning of Article 8(b) of the Protocol to the Convention for the Avoidance of Double Taxation concluded between Italy and France ("**Convention**"), which allocates concurrent taxation to both the source State (Italy) and the residence State (France) in the case of a transfer of shareholdings equal to or exceeding 25% of the profits of the company sold.

As a result of the disposal, FrenchCo realized a capital gain that was fully subject to Italian corporate income tax ("**IRES**"), amounting to an effective tax of 13.673% (i.e. IRES at a rate of 27.5% applied to 49.72% of the amount of the capital gain) according to the applicable rules in force at the time. Conversely, on the same gain an Italian tax resident company would have enjoyed the Italian Pex regime and would have been subject to an effective tax of 1.375% (i.e. IRES at a rate of 27.5% applied to 5% of the amount of the capital gain). FrenchCo therefore filed a refund request with the Italian Revenue Agency ("**Revenue Agency**") for the excess tax paid, claiming that the Italian Pex regime is contrary to the freedom of establishment and the free movement of capital, as codified by Articles 49 and 63 of the Treaty on the Functioning of the European Union ("**TFEU**") respectively as it does not apply to capital gains realized by companies resident in other EU Member States.

The Revenue Agency rejected the refund request and FrenchCo appealed against such decision, thus resulting in litigation. The Supreme Court, upholding the decisions of the first and second-tier tax courts, ruled in favour of the taxpayer and confirmed the right to refund. The Supreme Court's reasoning is as follows:

i. The non-application of the Pex regime to FrenchCo is an infringement of the EU fundamental freedoms. This is confirmed by the fate of the now repealed domestic rule that limited the dividend exemption regime to Italian resident companies (and Italian permanent establishments of non-resident companies) only. Indeed, the Supreme Court states that, following the decision of the Court of Justice of the European Union

("**CJEU**") in Case C-540/07 (*Commission v. Italy*), Italy decided to eliminate any discriminatory treatment related to the application of withholding taxes on outbound dividends by extending the Italian dividend exemption to non-resident entities through the introduction of a new paragraph 3ter to Article 27 of Presidential Decree No. 600 of 1973. According to the Supreme Court, and contrary to what the Revenue Agency argued, the same rationale behind the mentioned CJEU decision fully applies to the Pex regime, since both types of exemptions aim at avoiding economic double taxation by taxing the income only once in the hands of the entity that generated it at the time of its generation and considering any subsequent distribution as wholly or partially tax neutral.

ii. Restrictions under EU law cannot per se be overcome by other benefits granted by applicable double tax treaties. More specifically, here the Supreme Court deemed the foreign tax credit available to FrenchCo under the Convention for taxes paid in Italy to be insufficient because:

   (a) from a legal/formal point of view, the elimination of unjustified differences in treatment between companies tax resident in Italy and in other EU Member States has a different legal basis from the reduction or elimination of double taxation, which is the purpose of the tax treaties; and
   (b) from a factual/substantive point of view, FrenchCo could only be able to recover only a part of the tax paid in Italy, due to application of the participation exemption regime in France.

The Supreme Court's decision is particularly important because it equates the treatment of capital gains realized by EU residents with that of Italian residents (or Italian permanent establishments), as long as the conditions for the application of the Pex are met. From a practical perspective, it may lead non-resident companies to consider filing refund applications for tax periods that are not yet statute-barred.

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