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TAXATION OF FOREIGN BANKS IN ITALY

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edited by
Alessandro Catona
Michele Gusmeroli

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Taxation of foreign banks in Italy

Foreword

The Association of Foreign Banks in Italy (Associazione Italiana Banche Estere, AIBE) is pleased to release the first edition of the volume on taxation of foreign banks in Italy.

This book fills a void.

There was a need for something pitched at this level: neither superficial, nor academic. Something useful for both the head office tax director wanting to understand the specific feature of the Italian tax system and the finance person with no time to waste, but an issue to solve.

AIBE is thankful to leading members of PwC TLS who undertook the writing and editing of this book, which we hope will be constantly updated (in line with the many changes Italian tax law is undergoing).

Guido Rosa
AIBE President

PwC TLS welcomed AIBE's request with enthusiasm. Our contribution is part of a path that we started on many years ago, acting as a technical advisor of AIBE Tax Commission. For us, this is a natural milestone of our path – one that we hope will be the first of many - that sees the PwC brand standing side by side with an association as eminent as AIBE.

Fabrizio Acerbis
PwC TLS Practice Leader

Introduction

This book aims to provide English-speaking business executives and tax directors of foreign banks with an adequate level of understanding of some Italian taxes levied on their operations.

After more than 20 years in the business, we found that two kind of people are usually interested in this kind of information. On the one hand, there is somebody at a head office level (or sometimes at a foreign branch) inquiring on whether or not and to what extent a certain transaction will be affected by Italian taxes. On the other hand, many foreign banks with an Italian branch very often need some suitable understanding – neither basic, nor too detailed – of Italian business income technicalities, without wasting the time of their Italian tax people in abridging and simplifying the relevant provisions.

Part 1 deals with the former perspective: that of a foreign bank directly providing services in Italy. First and foremost, Italian source taxation of foreign lenders is tackled: this information is fundamental in deciding whether or not and how to structure a loan to an Italian borrower. Three chapters are then devoted to indirect taxes, specifically affecting financial intermediaries: the stamp duty, the substitutive tax and the financial transaction tax. Last but not least, the various forms of interaction with the Tax Authority are dealt with: from the business-friendly rulings to the (rather less friendly) litigation.

Part 2 deals with the latter perspective: that of a foreign bank with an Italian permanent establishment. The first chapter deals indeed with the PE definition, under both Italian domestic law and double tax treaties. The second chapter then deals with the attribution of profits to banking PEs and the extremely complex issue of free capital allocation. Business income is then tackled in the following chapters: first an introduction to business income deals with the main accounting features; then specific banking items are taken into account: credits, securities and derivative contracts and the notional interest deduction. The final chapter is then devoted to the Italian Regional Tax and its peculiar features.

Tax laws constantly change – and the Italian one for sure is no exception. As the subject matter of this volume is evolving fast, it will become outdated and a new edition will soon be needed. We plan this to be the first of many editions to come. This edition reflects the law as it stood on 31 December 2018.

Alessandro Catona
Michele Gusmeroli

Part 1

Italian taxation of foreign banks

Chapter 1

Italian source taxation of foreign lenders

Michele Gusmeroli | Caterina Innamorato | Marianna Franchini

1. Taxation of non-resident entities – In general

Under Article 23 of Presidential Decree no. 917 of December 22, 1986 ("ITC"), the following income items derived by a non-resident are regarded as Italian-source (and accordingly taxed in Italy):

a) income and gains from real estate assets situated in Italy;
b) income from capital paid by the government, by Italian resident persons or by Italian permanent establishments of non-resident persons, except for interest and other proceeds accruing on bank deposits, bank accounts or postal savings deposits;
c) business income derived through a permanent establishment in Italy;
d) capital gains derived from property situated in Italy or activities carried out in Italy;
e) capital gains on the transfer of participations in Italian companies, except for capital gains on participations that represent no more than either 2% of the voting rights or 5% of the stated capital of a listed company;
f) royalties paid by the government, by Italian resident persons or by Italian permanent establishments of non-resident persons.

For non-resident companies without a permanent establishment ("PE") in Italy, Italian-source income is taxed on an item-by-item basis (*"trattamento isolato del reddito"*) and in accordance with the rules applicable to each category of income.

Conversely, in case the Italian-source item of income is attributable to an Italian PE of the non-resident entity, it is taxed as business income in the hands of the PE, according to the rules set forth for resident companies. In this regard, non-resident companies are subject to local tax IRAP only if they maintain a permanent establishment in Italy for more than 3 months (for further details see Part 2, Italian permanent establishments of foreign banks).

As it may be noted, under letter (b) of Article 23 of ITC, interest and other proceeds accruing on bank deposits, bank accounts or postal savings deposits derived by non-resident entities are not considered to be Italian-source income and, therefore, are excluded from Italian taxation irrespective of the Country of residence of the recipient.

The non-resident entity that intends to benefit from such exemption is required to provide the bank or Poste Italiane S.p.A. with a declaration form ("autocertificazione") stating that it is a resident, for tax purposes, in a State other than Italy.

The following paragraphs deal with the Italian tax regime of items of income that foreign lenders generally derive in Italy when not acting through a PE.

2. Capital income and capital gains

When not acting through a PE in Italy, non-resident banks most commonly derive the following items of Italian-source income:

- capital income, generally consisting in the remuneration for making available financial resources to a third party, such as dividends, interest, guarantee fees, etc. defined under Article 44 ITC and determined under Article 45;
- capital gains, arising from the sale for consideration or redemption of financial instruments, defined under Article 67 ITC and determined under Article 68.

Capital income takes precedence over capital gains: whenever the same taxable event triggers both capital income and capital gains, then capital income is determined first and capital gains are calculated on a residual basis, by subtracting any amount already taxed as capital income.

Generally, capital income is taxable on a cash basis, i.e. when the proceeds are paid to the beneficial owner (while the moment in which the right to receive the sums has risen is not relevant); the taxable base is the sum of interest and other proceeds received in the tax year, without any deduction. Capital gains are also taxable on a cash basis and are calculated as the difference between sale (or redemption) proceeds and cost basis. While capital income may only be positive, capital gains may also be negative (in this case, capital losses may be carried forward up to the fourth future fiscal year).

Both capital income and capital gains, derived by non-residents not carrying on business in Italy through a PE, are usually subject to a final or advance withholding tax or to a substitute tax, whose rate is generally fixed at 26%.

3. Capital Income

3.1. WHT on capital income

As a general rule, under Article 26(1) to 26(5) of Presidential Decree No. 600 of September 29, 1973 ("Decree 600/1973"), Italian-source interest and other capital income paid to non-resident entities are subject to a final withholding tax at 26% rate, levied by the person that paid such interest or income from capital. The withholding tax is 12.5% on interest from government bonds and bonds issued by certain project finance companies (project bonds).

Article 26(2) of Decree 600/1973 provides for certain exemption regimes for bank-to-bank transactions. Specifically, according to Article 26(2)(a), the 26% withholding tax does not apply to payments of interest and other proceeds (objective condition), provided that such payment is made from Italian banks and Italian PE of foreign banks to foreign banks and foreign PE of Italian banks (subjective condition).

With reference to the objective condition, no specific guidance is available about the items of income to be considered falling within the notion of "interest and other proceeds" referred to in Article 26(2). However, when commenting the domestic provision for interest expense deductibility, Italian tax authorities have clarified that a substantial approach should be taken when interpreting the notion of "interest". By way of example, the following items, to the extent stemming from a transaction having a financial nature, were indicated as falling within the notion of interest:

- costs connected to discounts on loans obtained from banks or other financial institutions;

- fees on loans or guarantees;
- other expenses from debt securities issued, including issue discounts and redemption premium;
- expenses incurred by the borrower in securities lending transactions.

Whether such interpretation should also be applicable for the purposes of interpreting the notion of "other proceeds" as it is used under Article 26(2) of Decree 600/1973 was not officially clarified, although we would tend to consider that the above-mentioned elements should reasonably qualify as interest and other proceeds also within the context of such provision.

As to the subjective condition, Article 26(2)(b) of Decree 600/1973 does not seem to be particularly stringent: interest and other proceeds should not be subject to the 26% withholding tax to the extent they are paid from an Italian bank (including a PE of a foreign bank) to a foreign bank (including a foreign PE of an Italian bank), regardless of the country in which the recipient is resident or established. However, although it is not expressly stated so, according to a common and consolidated interpretation of the rule, the recipient of the interest and other proceeds should be the beneficial owner of such income.

3.2. WHT exemption for medium/long-term loans

Article 26(5-bis) of Decree 600/1973 provides that no WHT applies to Italian source loan interest, provided that four requirements are jointly met:

a) there should be no breach of regulatory provisions;
b) the lender should qualify as an EU bank / insurance or as a white list institutional investor;
c) the borrower should be an enterprise;
d) the loan should qualify as medium/long-term.

From a *regulatory* perspective, there should be no breach of provisions regulating the granting of loans to the public. This does not necessarily mean that the lender must be authorized to grant loans to the public in Italy: many foreign lenders (especially non-EU ones) would fall short of this requirement. The no-breach test may also be satisfied by the transaction falling out of the scope of provisions regulating the granting of loans to the public: this may happen when the transaction falls short of qualifying either as "granting of loans" or as "directed to the public" (e.g. loans within the same group).

From a *personal* perspective, interest should be received by an eligible lender. Eligible lenders are (i) EU banks, which should include European PEs of non-EU banks; (ii) EU insurances, which appear not to include European PEs of non-EU insurances; (iii) certain European entities specifically detailed (generally, public development institutions) and (iv) "white list" institutional investors. "White list" is a list of countries providing a suitable exchange of information with Italy: the list is provided by decree 4 September 1996 (regularly updated) and nowadays contains most world countries. The issue arises as to whether or not non-EU banks and insurances (which cannot qualify as such) could qualify as white list institutional investors, since banks and insurances fall within the scope of institutional investors.

From a subject matter perspective, interest should be paid by a borrower qualifying as an enterprise. This is interpreted as "deriving business income", which means that all Italian companies should qualify, as well as Italian PEs of foreign companies. On the other hand, entities not deriving business income - or anyway absolutely exempt (e.g. real estate funds) – should not qualify as eligible borrowers.

From a timing perspective, market practice makes reference to substitute tax criteria in order to determine whether or not a loan qualifies as "medium/long-term". Under substitute tax rules, a loan is considered as medium/long-term if the contractual term exceeds 18 months. Contractual terms matter, not residual life: interest paid on a loan granted for more than 18 months does not lose the exemption in the last 18 months of its duration. Reference is made to "contractual" terms, i.e. resulting from the clauses provided by the parties. No relevance should be attributed to the actual duration of the financing transaction, which could depend on subsequent agreements or courses of action, inconsistent with the original contractual terms: in fact, formally short-term credit effectively ends up being long term by automatically being extended. Medium and long-term loans, however, may be subject to early termination.

3.3. WHT exemption for other capital income

Article 26-bis of Decree 600/1973 provides for a general exemption regime for certain items of capital income derived by non-resident entities.

According to such rule, the 26% withholding tax should not apply, inter alia, to interest and other proceeds from loans, deposits and current accounts (different from bank and postal accounts that are already exempt under Article 23 of ITC), except for proceeds stemming from money-lending activities and guarantee fees, to the extent paid to:

- international entities and organizations established in accordance with international agreements ratified in Italy;
- foreign institutional investors, whether or not subject to tax, established in White List States (for the notion of "institutional investor" see §3.4); or
- Central Banks or entities that manage, inter alia, the official reserves of a foreign state (i.e. sovereign wealth funds).

The foreign beneficial owner that intends to benefit from the exemption must provide the Italian withholding agent with a declaration stating that it is a resident, for tax purposes, in a White List State. Such declaration must be compliant with the requirements set forth by a Decree of the Ministry for the Economy and Finance of December 12, 2001 (as amended and supplemented), and is valid until withdrawn or revoked and need to be submitted again in case of change of the identifying data of the beneficial owner.

3.4. WHT exemption for bonds

Legislative Decree No. 239 of April 1, 1996 ("Decree 239/1996") regulates the tax treatment of interest, premiums and other income (including the difference between the redemption amount and the issue price) from bonds, commercial papers and similar securities, to the extent:

a) they are issued by the State, by banks or by companies, whose shares are listed on a regulated market or on a multilateral trading platform of White List States; or
b) they are listed on a qualifying regulated market or on a multilateral trading platform of EU and EEA Member States; or
c) they are held by qualified investors (as defined under Article 100 of the Italian Securities Act).

When debt instruments are issued by companies whose shares are not listed on a regulated market nor on a multilateral trading platform of White List States, the whole tranche of such debt instruments should be listed upon issuance, for the purposes of condition (b) above.

Consistently, for the purposes of condition (c), the whole tranche of issued debt instruments should be held by qualified investors.

Generally, capital income derived by such debt instruments is subject to a substitute tax levied at 26%; however, a specific exemption is available to the extent:

- the payments are made to non-resident beneficial owners of the interest, with no Italian PE to which the debt instruments are effectively connected; and
- such beneficial owners are resident, for tax purposes, in White List States.

Decree 239/1996 also provides for additional exemptions from substitute tax for payments of interest in respect of the debt instruments falling within its scope made to: (i) international entities and organizations established under international agreements ratified in Italy; (ii) "institutional investors" whether or not subject to tax, established in White List States; and (iii) Central Banks or entities also managing the official reserves of a foreign State (e.g. sovereign wealth funds).

There is no legislative definition of "institutional investor". However, Tax Authority practice statements encompass those entities which, regardless of their legal or tax status in their country of residence, have as their principal activity that of managing investments on their own account or on behalf of third parties, such as e.g. insurance companies, investment companies, investment funds, SICAV (Open-end investment companies) and pension funds. According to Italian Tax Authorities, as long as a foreign entity has a specific expertise in managing financial instruments – to be expressly declared by its legal representative – it should be considered as an "institutional investor" for WHT exemption purposes. Nevertheless, when an entity is set up for the sole purpose of benefitting from the WHT exemption, such exemption should be denied: this is the case, for example, of "closed clubs", i.e. entities managing investments for a limited number of participants (most of which would not have been entitled to the WHT exemption on their own right) and whose activity is not supplied on the market.

In order to benefit from the bond interest WHT exemption, the above-mentioned non-resident entity must:

a) deposit the debt instruments in due time, together with the coupons relating to such debt nstruments, directly or indirectly with an Italian intermediary (or a PE in Italy of a foreign bank or financial intermediary), or with a foreign operator participating in a centralized securities management system which is in contact via computer with the Ministry of Economy and Finance; and
b) file in due time with the relevant depository a declaration ("autocertificazione") stating, inter alia, that it is resident, for tax purposes, in a White List State. Such declaration is valid until withdrawn or revoked and need not be submitted where a certificate, declaration or other similar document meant for equivalent uses was previously submitted to the same depository. The declaration is not required for international entities and organizations established under international agreements ratified in Italy and Central Banks or entities that also manage the official reserves of a foreign state.

Failure to comply in due time with the procedures set forth in Decree 239/1996 and in the relevant implementation rules will result in the application of the WHT on the interest payment received.

3.5. Double Tax Treaties

The 26% domestic WHT rate may be reduced (generally to 10 percent, in a few cases to zero) under double tax treaties entered into by Italy, when the conditions for the application of those treaties are met.

The vast majority of double tax treaties concluded by Italy is aligned to the OECD Model Convention on Income and Capital. Generally, cross-border interest payments are dealt with under Article 11 of double tax treaties, allowing the source State to apply a limited withholding tax on interest payments not exceeding (often) 10 per cent of the gross amount of the interest, provided that the beneficial owner of the interest is a resident of the other Contracting State.

Double tax treaties generally contain a definition of interest, which includes income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as interest for the purpose of Article 11.

Withholding agents have the right, under their responsibility, to directly apply the exemption or the lower tax rates provided for in the double tax treaties in force between Italy and the State of residence of the recipient of the income.

In case withholding agents do not apply directly the reduced taxation provided for under a treaty, the income recipient is allowed to claim the refund of the taxes charged in excess of those provided for under the treaty. The non-resident recipient may submit a refund claim by form if available, or by informal claim to the Centro Operativo di Pescara (Pescara Operational Centre), within the limitation period of 48 months from the tax payment date.

Italy has agreed with the competent authorities of Germany, Portugal, the United Kingdom, Switzerland, Sweden and the United States, the use of specific forms to be used for claiming partial or total refund of withholding tax charged in excess of the rate provided for under the relevant double tax treaty.

The Italian Revenues director, through a measure dated 10 July 2013 (Prot. N. 2013/84404), has approved a specific Model that the income recipient should file with the paying agent for purposes of benefitting from the application of a double tax treaty. For interest payments, the recipient of the income should fill in the Cover Page and Form B of such Model, which also includes a section whereby the tax authorities of the country in which the recipient is a resident should declare that such person is resident therein for the purposes of the double tax treaty whose application is requested. Such Form can be filed for the request of both (i) the direct application of the reduced treaty rate and (ii) a refund of withholding tax rate applied in excess of that provided for under the tax treaty when the relevant conditions are met, to be filed with the Pescara Operational Centre.

In case of request for direct application of a double tax treaty, the withholding agent must keep the forms together with the necessary documentation for future audits of the Italian Tax Authorities. All documentation should be kept available to the Italian Tax Authorities, until the statute of limitation expires for tax assessment purposes, or until the relative assessments have been concluded. Also, the foreign tax authorities' certification contained in (or attached to) the Form shall be valid for the tax period in the statement starting from the issue date, provided that all other requirements are met.

Notably, the filing of such documentation with the paying agent for purposes of requesting

the direct application of the double tax treaty, although advisable, should not be considered as a precondition to the right to benefit from a double tax treaty. In other words, a withholding agent should in principle not be considered as liable in case of direct application of a double tax treaty when, even in the lack of such documentation, the recipient of the income satisfies all the requirements for the application of the relevant double tax treaty (and is able to prove that such requirements are met).

3.6. The beneficial ownership clause

Whilst double tax treaty articles dealing with interest most commonly contain a beneficial ownership clause, relevant domestic rules allowing for a withholding tax exemption (with the exception of Article 26-quater of Decree 600/1973) do not expressly require the recipient of the income to be the beneficial owner thereof. However, it is commonly understood that exemptions from withholding and substitutive tax on interest should be granted only if the recipient is the beneficial owner of the income.

The Italian Tax Authorities, as well as tax courts, have in several instances dealt with the subject matter, although not always in a consistent manner. Generally, the beneficial ownership requirement should be considered met where the proceeds are attributed, for tax purposes, in the hands of the recipient in its country of residence and such recipient does not act as an agent or nominee for another person. Broadly speaking, if the recipient is the residual claimant of the income, not acting in a "back-to-back" position, there are grounds to argue that it is the beneficial owner of such income.

In any case, there are other requirements that Italian tax authorities generally take into consideration for purposes of the beneficial ownership test. For example, exemptions provided under domestic law or treaties may be denied if the recipient does not have the full right to use and enjoy the income received, or it does not derive an economic benefit from the transaction generating the income. Conversely, the beneficial ownership test should be met if the recipient decides how to re-invest the flows it receives, and there are no contractual arrangements, putting such recipient under an obligation to transfer the income to other parties (e.g. no back-to-back financing schemes).

In a nutshell, for a person in order to qualify as the beneficial owner of an income, it is not sufficient that such income is attributed to such person under income tax law of its country of residence, but is also necessary such item of income to be effectively available to him. Anyway, a functional analysis of the activities carried out (i.e. of the economic substance of the subject) and of the decision-making process on how to use such income is often needed. Moreover, the notion of beneficial owner is an ever-changing issue and both Italian Tax Authorities' approach and case law on the matter are constantly changing.

3.7. The Interest - Royalty Directive

As an EU Member State, Italy has implemented EU Council Directive 2003/49/CE ("Interest - Royalty Directive") on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States.

Interest - Royalty Directive rules are implemented in Article 26-quater of Decree 600/1973, under which no withholding tax should apply on interest payments if the person making the payments and the beneficial owner of the payments are companies that fulfill the requirements set out in Annexes A and B of the Decree implementing the Interest - Royalty Directive in Italy

("EU Company").

More specifically, an EU Company should (i) take one of the forms listed in Annex A, (ii) be resident in a EU country for tax purposes, not being considered resident for tax purposes in a non-EU country under the terms of a double tax treaty, and (iii) be subject to one of the taxes listed in Annex B without the possibility to be exempt.

The exemption should also apply when interest payments are made through, or attributable to, PEs situated in an EU Member State of EU Companies. To such extent, a PE should be treated as the payer of interest (or royalties) only insofar as those payments represent a tax-deductible expense of such PE in its country of establishment. By the same token, a PE situated in an EU Member State of EU Company should be treated as the beneficial owner of interest to the extent such interest are effectively connected to such PE and subject to tax in the Member State it is situated in its hands.

A further condition requires that the company that makes the payment and the company that benefits from the payment must be associated as per the wording of the Interest - Royalty Directive, i.e.:

- the first company directly holds a participation equal to at least 25% of the voting rights in the second company; or
- the second company directly holds a participation equal to at least 25% of the voting rights in the first company; or
- a third company, fulfilling the requirements under Annexes A and B of the Decree, directly holds a participation equal to at least 25% of the voting rights in both the first and the second companies.

The above-mentioned participations must be held for an uninterrupted period of at least 1 year.

Also, the exemption should apply only to the extent interest paid to a EU Company are subject to one of the taxes listed in Annex B or to substantially similar taxes or substitutive taxes.

The term "interest" shall include income from debt claims of every kind, whether or not secured by mortgage, and in particular income from securities and income from bonds or debentures, including premiums and prizes attached to such securities, bonds or debentures.

The exemption does not apply where the amount of the interest exceeds the amount that would have been agreed by the payer and the beneficial owner in the absence of a special relationship between them. A special relationship exists when one party directly or indirectly controls the other, or when both parties are directly or indirectly controlled by the same third party.

The request for the application of the exemption regime must be substantiated by (i) a certificate of the tax authorities of the beneficial owner's residence country and (ii) an affidavit of the beneficial owner regarding the fulfilment of the legal form and subject-to-tax requirements. Importantly, such documentation should be provided to the paying agent before the interest payment date.

The Italian Revenues director, through a provision dated 10 July 2013 (Prot. N. 2013/84404), has approved a specific Model that the income recipient should file with the paying agent for purposes of the exemption under the Interest – Royalty Directive. The income recipient should fill in the Cover Page and Form F of such Model, whereby all the requirements for the application of the Interest – Royalty Directive are listed. The Form shall be completed with the statement of the tax authority of the beneficial owner's country of residence (or that

in which the PE is established). Such Form can be filed (i) with the withholding agent, for the direct application of the withholding tax exemption or (ii) with the Pescara Operational Centre, for the refund of any withholding tax applied.

If, at the moment of payment, the minimum period (one year) of holding of voting rights has not expired, the withholding tax must be applied and a refund request must be filed. In case of direct application of the Interest - Royalty Directive, all documentation shall be kept available to the Italian Tax Authorities until expiration of the statute of limitation, or until the relative assessments have been concluded. The form is valid for one year from the date of the tax-residence statement issued by the foreign tax authority, provided that no material change takes place during this period.

The form can also be used by certain companies resident in Switzerland, under the Agreement between the European Union and the Swiss Confederation on taxation of savings income, which also grants to Swiss companies the tax regime established in the Interest - Royalty Directive.

4. Capital gains - Highlights

Under Article 23 of the Income Tax Code, non-resident entities are taxable in Italy on capital gains derived from, inter alia, participation in Italian companies.

Different tax consequences arise depending on whether or not a "qualifying participation" is sold. A participation is considered qualifying if exceeding 2% of voting rights in the ordinary shareholders' meeting or 5% of capital in a listed company; for unlisted companies, the percentages are 20% of voting rights in the ordinary shareholders' meeting or 25% of capital. A participation is considered non-qualifying if not exceeding either of the above thresholds.

Capital gains derived from the alienation of a non-qualifying participation in a listed company are not considered as sourced in Italy. Capital gains derived from the alienation of a non-qualifying participation in a non-listed company would be subject to a 26% substitutive tax. However, White List entities are not taxable in Italy on capital gains derived from the sale of a non-qualifying participation in any Italian company (whether listed or not). Capital gains derived from the alienation of a qualifying participation, on the other hand, can only escape Italian source taxation under a double tax treaty; otherwise, they are taxable at a 26% flat rate (until 31 December 2018, a transitional regime applies).

Most double tax treaties concluded by Italy provide that capital gains on shares are only taxable in the State of residence of the seller. However, some double tax treaties contain a "real estate company provision", under which the State where real estate is situated retains its taxing rights, even when such real estate is held by a company, whose shares are later sold. Moreover, a few treaties contain a "substantial shareholding provision", under which a capital gain is taxable also in the State where the company sold is resident, whenever the seller exceeds a certain participation threshold.

Chapter 2

Stamp duty

Marco Vozzi | *Edgardo Gagliardi*

1. Introduction

The Italian stamp duty tax ("stamp duty") has a peculiar role in Italy, with reference to the banking business. Even if its amount in term of revenues is not relevant compared to direct taxes and VAT, most of the acts and documents issued by banks and other financial intermediaries are subject to such tax. In recent years, the Italian stamp duty has been subject to relevant developments, due to new technical methods of application and to comprehensive changes with reference to the stamp duty applicable on bank statements and on communication to clients regarding financial products. These last developments have raised concerns and criticism, considering that such taxes are more similar to wealth taxes rather than to a proper stamp duty tax and under certain circumstances can be extremely burdensome for clients.

In the following paragraphs, the general framework will be presented of the Italian stamp duty tax, starting from its principal characteristics as a "paper tax". This will be discussed in paragraph 2. In paragraph 3, the application will be discussed of the stamp duty with particular reference to the activity of banks. In paragraph 4 consideration with reference to the methods of payment of the stamp duty are presented with particular reference to the payment on a virtual basis.

2. General characteristics

2.1. Historical background and basic features

The stamp duty is governed by Presidential decree n. 642 of 26 October 1972 ("Presidential decree 642/1972) and in its attached Tariff (ANNEX A) and Table (ANNEX B). The origins of the stamp duty are extremely ancient and articulated. Indeed, considering only the last century, it is possible to identify many legislative provisions concerning the stamp duty, until the comprehensive tax reform that led to the development of Presidential decree 642/1972.

Originally, the stamp duty was intended as a tax to be levied on the mere "consumption of paper" for official documentation. With the introduction of Presidential decree 642/1972, the importance was highlighted of the stamp duty as a tax that grants the "juridical use" of acts and documents in any juridical or administrative proceeding.

More in detail, the stamp duty has the nature of a "paper tax" (*"imposta cartolare"*) as it must be applied over the existence of an act, document or register on paper. Indeed, the expression of any tax liability under the stamp duty legislative framework was connected over the existence of a material piece of paper.

[1] As disciplined by Presidential decree n. 131 of 22 December 1986.

Conversely, the registration tax[1] has the nature of a "deed tax" (*"imposta d'atto"*) to the extent that it awards "juridical significance" to a legal deed and confers certain date to such deed.

In the Italian tax system, the stamp duty is classified as an "indirect tax" and as a "minor tax". It considered an "indirect tax" as it applies on mediated expression of wealth and is considered as a "minor tax" considering its revenues are not of relevant importance. However, with particular reference to banks, its impact should not be underestimated considering that it finds application on most of the documents released by banks and might adversely affect certain transactions.

2.2. Transfer of ownership

The stamp duty applies to the formation of acts, documents and mandatory registers indicated in the attached Tariff of Presidential decree 642/1972. The Tariff provides as well indications on the computation of the stamp duty with reference to each different act.

According to Presidential decree 642/1972, acts, documents and registers can be either:

- subject to stamp duty since their origination,
- subject to stamp duty "in case of use", or
- exempt from stamp duty "in absolute manner".

The Tariff is articulated and analytically identifies all the acts, documents and registers subject to the stamp duty and is divided in two parts:

i) Part I which identifies the documents that are subject to stamp duty since their origination *("Allegato A - Tariffa - Parte I - Atti documenti e registri soggetti all'imposta fin dall'origine")* and

ii) Part II which identifies the documents which are subject to stamp duty "in case of use" *("Allegato A - Tariffa - Parte II - Atti documenti e registri soggetti all'imposta in caso d'uso")*.

After the Tariff there is a Table which identifies the acts, documents and registers exempt from stamp duty "in absolute manner" *("Allegato B - Tabella - atti, documenti e registri esenti dall'imposta di bollo in modo assoluto")*. Such acts are not subject to stamp duty neither in case they are used toward public administration, or in juridical proceedings.

In addition, it should be remembered that, by virtue of the coordination with article 15 of Presidential decree n. 601 of 29 September 1973 ("Presidential decree 601/1973"), loan agreement subject - *ab origine* - to the substitutive tax on medium and long term loan agreement, are exempt from stamp duty by explicit provision of law (see chapter XX for a detail explanation of the substitutive tax on medium and long term loans).

As far the subjective requirement is concerned, Presidential decree 642/1972 does not explicitly indicate who is the subject liable for the payment of the stamp duty. It rather specifies, according to article 22, that i) all the parts that subscribe, receive, accept or negotiate acts, documents or registers not compliant with the payment of stamp duty[2] and ii) everyone that makes use of acts subject to stamp duty since its origination without applying the stamp duty, are jointly liable for the stamp duty due. Accordingly, it is possible to derive that both the issuer and the subject towards which documents are released are jointly liable for the payment of the stamp duty. The only exception is represented by transactions with the State .

[2] Also in the case of "enuciation" or in case such acts are attached to other acts.

Indeed, in any transaction involving the State[3], by explicit provision of law, the burden of the stamp duty is shifted to the other part involved[4] (the bank in the particular case).

In general, acts not compliant with the stamp duty are effective (except with reference to particular cases explicitly mentioned) and the party towards whom an act not compliant with the stamp duty is presented, has no responsibility if within 15 days provides for the regulation of the stamp duty.

As far as territoriality is concerned, with reference to acts, documents and registers subject to stamp duty since their origination (as listed in the Tariff - Part I), the stamp duty is due provided such documents are formed in Italy. Acts formed abroad are generally subject to stamp duty "in case of use".

3. Application of the stamp duty tax in the banking sector

Banks operating in Italy are required to verify the application of the stamp duty with reference to acts and documents related to operations towards their clients, and must take care of the related payment procedure. As previously noted, Presidential decree 642/1972 does not provide any indication with reference to the subject that must bear the tax burden of the stamp duty. However, it is customary, especially in the banking sector that contractual relationship provides for the charge of stamp duty to clients with the only exception - a previously mentioned - of acts and documents whose counterpart is the State.

In the following sub-paragraphs, the most relevant rules for the application of the stamp duty with particular reference to the banking sector are presented. However, it is opportune to highlight the fact that the application of the stamp duty is extremely articulated and strictly connected to the bank's duties under the Italian legislative and regulatory framework. In the light of this, the discussion below is aimed to highlight the main articles of the Tariff and to provide the reader some guidelines for the application of the stamp duty with no presumption of being exhaustive.

3.1. Acts and documents subject to stamp duty upon their origination

With reference to acts and documents that are subject to stamp duty since their origination the most relevant provision are the following:

- article 2, note 2-bis, Tariff - Part I, related to banking contracts and operations, financial contracts and agreement for consumer credit;
- article 6, Tariff - Part I, related to promissory notes and similar instruments;
- article 9, Tariff - Part I, related to bank cheque;
- article 10, Tariff - Part I, related to cashier's cheque;
- article 13, Tariff - Part I, related to invoices, bank account statements, savings book statements and communications to clients related to financial products;
- article 14, Tariff - Part I, related to bank receipt;
- article 16, Tariff - Part I, related to accounting books and register.

In general terms, banking contracts, contracts concerning investment services and documents that support evidence of such agreements, should be subject to stamp duty in the fixed amount of Euro 16,00.

[3] The State must be identified with in a restrictive manner. It does not comprehend regions, municipalities, provinces, universities and other public entities.

[4] As explicitly provided by article 8 of Presidential decree 642/1972.

In this regards, note 2-bis of article 2 of the Tariff - Part I, establishes that with reference to contracts related to banking services and their operations, contracts related to investment services and agreement for consumer credit *("contratti relativi alle operazioni e servizi bancari e finanziari e contratti di credito al consumo")*, the amount of the stamp duty should be charged only once, notwithstanding the number of pages or the number of copies of contracts released. Such disposition introduce a derogation to the general rule according to which the fixed amount of 16,00 Euro should be charged for every sheet (being every sheet as made of 4 pages according to article 5 of Presidential decree 642/1972). This simplification was introduced to lower the tax burden toward clients, considering that banking contracts imply the amount of many sheets and copies.

However, as it will be further explained below, in case of bank accounts and deposits subject to the "periodical" stamp duty, by virtue of the "substitutive effect" of the periodical stamp duty, the stamp duty in fixed amount is not due with reference to such contracts.

Promissory notes *("cambiali")* and similar instruments issued in Italy, are subject to stamp duty at proportional rates depending on the specific case (1,2%, 0,9%, 1,1% or 0,1%). Postdated bank cheques *("assegni postdatati")* are subject to stamp duty at proportional rates in the same amount of promissory notes. If the obligation of paying the stamp duty with reference to promissory notes and to postdated bank cheques is not fulfilled, by explicit law provisions such documents cannot be regarded as "executive titles".

Cashier's cheque ("assegni circolari") are subject to stamp duty at the proportional rate of 0,6% per annum applicable on the amount of outstanding cashier's cheque still in circulation at end of each trimester.

According to article 13 of the Tariff - Part I, invoices, notes and similar documents providing evidence of credit and debit and other receipt issued by creditors - or by third parties on his behalf - *("Fatture, note, conti e simili documenti, recanti addebitamenti o accreditamenti, ricevute e quietanze rilasciate dal creditore, o da altri per suo conto, a liberazione totale o parziale di una obbligazione pecuniaria")* are generally subject to stamp duty for an amount of 2,00 Euro per copy. However, no stamp duty is due providing the amount certified does not exceed 77,47 Euro or if the receipt is provided in documents already subject to stamp duty or exempt.

Article 14 of the Tariff - Part I, provides that bank's receipt *("ricevute bancarie")* are subject to stamp duty in fixed amount from 2,00 Euro to 6,80 Euro depending on the amount of the receipt.

In the end, article 16 of the Tariff - Part I. provides that accounting books and registers are subject to stamp duty in fixed amount of 16,00 Euro for every 100 pages.

3.1.1. Periodical stamp duty on bank statements, savings book statements and periodic communications to clients related to financial products: general discipline and substitutive effect

With reference to i) bank accounts statements provided from banks to their clients[5], savings book statements and to ii) the periodic communications to clients related to financial products, the disposition related to the application of the stamp duty have been extensively amended after the modification introduced by article 19 of Law decree n. 201 of 6 December 2011.

[5] Among others, the following subject are not regarded as clients: banks, Poste Italiane S.p.A., financial intermediaries, electronic money institutions, insurance companies, investment companies, mutual funds, SGR and pension funds.

Such disposition are governed by article 13, paragraphs 2-bis and 2-ter of the Tariff - Part I attached to Presidential decree 642/1972 and by Ministerial decree of 24 May 2012 ("regulatory decree").

In particular, according to article 13, paragraph 2-bis, of the Tariff - Part I - attached to Presidential decree 642/1972, bank statements and savings book statements *("estratti conto inviati dalle banche ai clienti, estratti di conto corrente postale e rendiconto dei libretti risparmio anche postali")* are subject to stamp duty periodically and in fixed amount.

The amount of the stamp duty depends upon the characteristics of the client, indeed, the amount of the stamp duty is:

- 34,20 Euro for individuals and
- 100,00 Euro for other subjects.

By explicit provision of law, the stamp duty is not due in case the client is an individual and the average amount of the balance of its account/s is lower than 5.000 Euro.

The stamp duty is computed on a *pro rata temporis* basis with reference to the period referred in the bank statement (a quarter, a semester or one year). Moreover, in the absence of the duty to transmit any statement, the legislator has introduced a presumption according to which a statement is considered sent once every year.

Periodic communications to clients related to financial products *("comunicazioni periodiche alla clientela relative a prodotti finanziari")* according to article 13, paragraph 2-ter, of the Tariff - Part I - attached to Presidential decree 642/1972, are subject to stamp duty periodically and at proportional rates.

In particular the rate was 0,1% for the first period (i.e. in 2012), 0,15% for 2013 and then 0,2% since 2014.

From 2014, in case of clients other than individuals, the stamp duty is levied up to a maximum amount of 14.000 Euro. No cap is applicable for individuals.

The communications that must be subject to the stamp duty are those related to financial products such as, among others:

- communications related to deposit account or savings accounts;
- communications related to certain asset management products;
- communications related to investment in shares of undertakings for collective investments;
- communications related to deposit certificates;
- communications related to unit linked, index linked insurances.

Also in this case, the stamp duty is computed on a *pro rata temporis* basis with reference to the period referred in the communication and, in the absence of the duty to transmit any communication (considering that clients can opt for not receiving any communication except for mandatory ones), a statement is considered sent once every year.

The stamp duty must be computed upon the values of the investments at the end of the period referred. If no communication is sent the values that should be considered are those at December 31st. If no market value is available, reference should be made to the nominal value or to the value of reimbursement of the investments. In the absence of any of the values above mentioned it should be considered the purchase price.

By virtue of note 3-ter of article 13, and of article 4, paragraph 4, of the regulatory decree, it is established that the stamp duty under i) and ii) above is "substitutive" to any other stamp duty applicable to acts or documents issued or received by banks, other financial institutions or by the Italian post office, related to operations concerning bank accounts, correspondence accounts, deposits or other portfolios related to financial products. For example, in case of a

bank account subject to the periodic stamp duty, by virtue of the "substitutive effect":

- the stamp duty is not due of 16,00 Euro on the contract for the opening of such bank account;
- the stamp duty is not due of 16,00 Euro on any other contract for banking and investment services related to such bank account;
- the stamp duty is not due of 0,258 Euro on any bank's cheque related to such account;
- the stamp duty is not due from 2,00 Euro to 6,80 Euro on any bank's receipt settled through such account;
- the stamp duty is not due of 2,00 Euro on any other operation (receipts, official balance statements, receipt related to various payment orders) settled through that account.

3.2. Acts and documents subject to stamp duty in case of use

With reference to acts and documents that are subject to the stamp duty in "case of use", it should be considered, in particular:

- article 24, Tariff - Part II, related to acts and documents formed by correspondence;
- article 29, Tariff - Part II, related to promissory notes and equivalent formed abroad.

According to article 2, paragraph 2 of Presidential decree 642/1972, there is "case of use" when acts, documents and registers are presented to the Tax administration (or other administrative body) for their registration.

In case of acts and documents formed by correspondence, stamp duty is due only in case of use. However, note 1 to article 24 of the Tariff expressly provides that private deeds, even if formed by correspondence, are subject to stamp duty if the written form of the agreement is expressly requested by law. Such is the case of contracts concerning banking services and operations that by explicit provision of law should be drafted in written form.

Foreign promissory notes are subject to stamp duty only in "case of use" with the same amounts as provided for Italian promissory notes. However, if the same notes are subject to stamp duty also in the state of origin, to mitigate the effect of double taxation, the amount due in Italy is reduced by an half. With particular reference to foreign promissory notes it established that there is case of use also when the note is presented, transferred, settled or accepted or with reference to any other form of negotiation.

3.3. Acts and documents exempt from stamp duty in absolute manner

With reference to acts and documents that are exempt from stamp duty in "absolute manner", reference should be made to articles 6 and 7 of the Table.

According to article 6 of the Table, any document (note, invoice and other document) related to VAT taxable transactions is exempt from stamp duty. Such provision express the principle according to which stamp duty is alternative to VAT taxable transactions. It should be highlighted that, according to article 6, only transactions where VAT has been effectively charged are exempt from stamp duty. Transaction subject to VAT but exempt or not subject are still transactions that might be subject to stamp duty.

Article 7 provides a list of acts, documents and registers principally related to securities and investments products, which are exempt from stamp duty. According to article 7, the exemption applies, among others, with reference to:

- bonds, similar securities and credit certificate issued by State and related receipts,
- shares, share quota, bonds and other trading securities and to all the related acts for

their creations, issuance, admission in a regulated market, circulation, negotiation of such securities.

In the end it should be remembered as well that any act and document related to loan subject upon origination to the substitutive tax on medium and long term loan agreements, by virtue of article 15 of Presidential decree 601/1973, is exempt to stamp duty.

4. Methods of payment of the stamp duty: payment on a virtual basis

Since the 1st of January 2007, all the former methods for the payment of the stamp duty have been abolished[6] and actually, the stamp duty is applied only in the following ways:

i) it can be paid directly to an authorized intermediary, which releases proper marks *(namely "contrassegno")*;
ii) it can be paid on a virtual basis directly to the tax administration provided a proper authorization has been obtained.

With reference to banks, it is of crucial importance the application of the stamp duty on a virtual basis governed by articles 15 and 15-bis of Presidential decree 642/1972.

The "virtual stamp duty" finds application with reference to particular categories of acts and documents. In general, contracts related to banking services, along with their related acts and documents and contracts for investments services, along with their related acts and documents are eligible for the application of the stamp duty on a virtual basis. Accordingly, the periodical stamp duty on bank accounts statements provided from banks to their clients, savings book statements and the periodical stamp duty on the periodic communications to clients related to financial products, can be reported on a virtual basis and paid accordingly. It goes without saying, that most of the stamp duty revenues reported by banks, by virtue of the "substitutive effect" of the periodical stamp duty, refers to such cases.

In order to apply the stamp duty on a virtual basis, the applicant must be duly authorized by the tax administration with a proper request indicating the number of the documents subject to stamp duty that are expected to be issued and received in the year of the application. Once authorized, the applicant must self-declare the number of documents subject to stamp duty issued during the year, with a proper declaration that must be submitted by the end of January 31st following the year when the authorization was obtained.

The payment of stamp duty occurs in advance based on the estimate provided by the applicant and is corresponded in equal instalments on a bi-monthly basis starting from February. When the declaration of the documents issued is received (by the end of January 31st after the year-end), the tax administration provides to liquidate the stamp duty definitely. The same declaration is also used to liquidate, in advance, the payments of the following year. Any credit or debit balance resulting from the final liquidation of the tax administration is then computed on the first instalment (and in the following in necessary).

With particular reference to banks, Poste Italiane S.p.A. (i.e. the Italian post company), other financial intermediaries[7] and insurance companies, it is established that such entities must pay as well an advance payment corresponding to 95% of the stamp duty liquidated for the current year. Such advance payment must be corresponded by April 16th, and it can be used to offset the instalments starting from February of the following year.

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[6] Stamped paper ("carta bollata"), paper stamp duty ("marche da bollo cartacee"), ordinary stamp duty ("bollo a punzone").

[7] As listed in article 1 of legislative decree of 27 January 1987, n. 87.

Chapter 3

Substitutive tax

Marco Vozzi | Michele Gusmeroli

1. Introduction

1.1. Overview

Title IV of Presidential decree n. 601 of 29 September 1973 ("Presidential decree 601/1973"), titled "benefits for the credit sector", contains the provisions that govern the application of the so-called "substitutive tax on medium and long term loans" ("substitutive tax")[1].

In recent years this particular regime has been subject to substantial amendments with reference, in particular, (i) to the fact that it is now possible to adopt this regime on an optional basis (until 2013, the application of the substitutive tax was mandatory) and (ii) to its scope of application, which has been extensively broadened.

In the following, an overview will be provided of the Italian substitutive tax regime. In particular, the remaining of this introductory paragraph will outline the historical background and the general framework of the substitutive tax. Paragraph 2 shall deal with the notion of "qualifying lender", the personal requirement for applying the substitute tax. Paragraph 3 will tackle the issue of "medium-long term loan agreement", the subject matter requirement to be met for applying the substitutive tax. Paragraph 4 shall define when a loan agreement is formed in Italy, the territorial requirement; this will be discussed considering the approach of the Italian tax administration that, in recent years, contested the application of the substitutive tax regime on deeds formed abroad under Italian "abuse of law" principles.

1.2. Historical background

The substitutive tax on medium and long term loans entered in force on 1st January, 1974; however, before that date, other facilitations to support the credit sector where in place[2].

From an historical perspective, there is a close connection between the substitutive tax and the former "subscription tax" *("imposta annua di abbonamento")* introduced by Law n. 1228 of 27 July 1962 (Law 1228/1962)[3]. Indeed, according to regime foreseen by Law 1228/1962, credit institutions, their subdivision or going concerns that exercise the activity of granting medium and long term loan facilities, were subject, instead of the ordinary regime, to a yearly "subscription tax" of 15 ITL cents for every 100 ITL (i.e. at a rate of 0,15%). The abrogated subscription tax was levied on a yearly basis and the taxable base was represented by the amount of the outstanding medium and long term loans booked in the balance sheet of the

1 "Imposta sostitutiva sui finanziamenti a medio-lungo termine", as disciplined by articles 15 to 20-bis of Presidential decree 601/1973 and following amendments and supplements.

2 See, for example article 21 of Royal decree n. 1509 of 29 July 1927, and Law n. 635 of 30 may 1932 subsequently amended by Royal law decree n. 1883 of 4 October 1935, concerning credit facilities with reference to the agricultural sector.

3 And abrogated by article 24 of law decree n. 112 of 25 June 2008.

lender at the year end. Under Law 1228/1962, medium and long term loans were loan of a duration of at least three years and such loans should have an investment purpose.

The subscription tax was substitutive of all the other direct and indirect taxes ordinarily applicable on medium and long term loans falling in the scope of the law and with reference to all the ordinarily applicable taxes on their related acts and formalities, for their execution, modification and cancellation[4].

Under the mandate of the tax reform that took place in 1972/1973, then, with the purpose to simplify the existing regime, the legislator introduced the current framework of the "substitutive tax" as governed by articles from 15 to 20 of Presidential decree 601/1973. The main difference with the former subscription tax is that the subscription tax was applied on a yearly basis, therefore, the same loan would have been subject to such tax every year even if on its (lower) existing amount (i.e. every year on the amount of the outstanding loan).

Conversely, as better explained in the following paragraphs, the substitutive tax applies on a lump sum basis upon the loan origination.

1.3. General characteristics

Since its introduction the substitutive tax was basically intended to simplify the granting of credit facilities by Italian banks, to the extent that its payment on a "one-time basis", upon the loan origination, "substitutes" the application of all the other indirect taxes generally due on loan agreements and on their related warranties and formalities.

If the relevant conditions for the application of the substitutive tax are met, accordingly, medium and long term loan agreements, are subject only to a flat tax on the amount of the loan and, contextually:

- all deeds, documents, agreements and formalities related to the **execution, amendment** and **redemption** of the medium-long-loan agreement, and
- all deeds, documents, agreements and formalities related to any **guarantee** of whatever nature granted by anybody at any time (i.e. "the security package") and
- its **subrogation, substitution, postponement** and **cancellation**, also partial, including any assignment of receivables made in connection with such transaction, are exempt from any other tax ordinarily due (e.g. registration tax, stamp duty, cadastral, mortgage and governmental concession tax).

The substitutive tax is levied at the fixed rate of 0,25% on the amount of the loan. In this regards, in most of the circumstances, the substitutive tax lowers the tax burden on loan transactions.

For example, according to the ordinary regime, financing transactions executed by VAT taxable persons, generally qualify as VAT exempt transaction and, if the agreement is executed by Notarial deed, a fixed registry tax of 200,00 Euro is due[5]. However, if the loan is guaranteed by a mortgage on immovable property, a 2% mortgage tax *("Imposta ipotecaria")*[6], is generally levied on the amount of the warranty[7], which is higher than the 0,25% substitutive tax applicable on the amount of the loan.

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[4] See in this sense also Ruling n. 43118/2000 of 20 December 2000 of the Ministry of Finance

[5] The application of registry tax is due also in cases of loan agreements signed by correspondence (where no taxes apply) and subject to registration "in case of use" (i.e. "caso d'uso", when the agreement is presented before a court or at any other administrative office) or in case of "enunciation" (i.e. "enunciazione" when a document is referred to or cross-referenced in a registered deed, agreement or other document entered into, executed or signed by the same parties of the referred agreement).

[6] According to article 6 of the Tariff attached to legislative decree n. 347 of 31 October 1997 ("Imposta ipotecaria e catastale").

[7] In case of pledge of shares registry taxes are levied at the rate of 0,5% on the amount of the warranty (under article 6 of the Tariff attached to Presidential decree n. 131 of 26 April 1986.

After the amendments introduced with Law decree n. 145 of 23 December 2013 ("Law decree 145/2013"), the substitute tax regime now applies upon election by the lender, while under the previous regime the application of the substitute tax was mandatory in case the relevant conditions for its application were met. In this regards, the application of the substitutive tax must be evaluated on a "case-by-case" basis, considering that in other circumstances the substitutive tax might result in a higher tax burden compared to the ordinary regime. Indeed, in case of a mere unsecured loan which is subject to a negligible fixed registry tax of 200,00 Euro, for example, the application of the substitutive tax at the rate of 0,25% is not favorable.

In many circumstances, the Italian Tax Authority took the position that the substitutive tax regime on medium and long term loans did not cover also the subsequent transfers or assignments of loans subject to the substitutive tax at origin; in this regard, subsequent transfers and assignments have been subjected to the ordinary indirect taxes due. However, the matter has been definitely resolved as a consequence to the fact that, following the recent amendments introduced with Law decree n. 91 of 24 June 2014 ("Law decree 91/2014")[8] it has been now clarified that the exemption from indirect taxes will also cover any *"subsequent transfer or assignment of the loan, of the receivables therefrom, and of any related security package"*.

At last, as far as the assessment aspects are concerned, according to article 20 of Presidential decree 601/1973, the substitutive tax is due by the lender (i.e. the bank) yearly and on a cumulative basis (i.e. with reference to the overall lending agreements granted in the tax year concerned). The possibility to charge the tax on the borrower is not precluded by the law but only the lender is liable for the substitutive tax due[9]. However, in case of unlawful application of the substitutive tax, the ordinary regime should have been applicable, therefore, both the lender and the borrower are jointly assessable for the ordinary the taxes due on the agreement (i.e. registry tax, mortgage tax, stamp duty) following the ordinary rules.

2. Personal requirement

The substitutive tax regime applies only if three requirements are jointly met:

A. the lender might be eligible for its application based on his personal status ("personal requirement");
B. only medium and long term loan agreements and other financing transaction specifically listed by explicit provision of law are eligible for the application of the substitutive tax ("subject matter requirement") and
C. the loan agreement must be formed in Italy ("territorial requirement").

Under article 15, paragraph 1, of Presidential decree 601/1973, qualifying lenders are defined as financial institutions that *"in conformity with the relevant legislative¸ statutory and administrative provisions, exercises the activity of granting medium and long term credit"*[10].

The definition of qualifying lender under article 15 is rather old and must be properly interpreted in the light of the relevant provisions of Italian banking law.

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[8] Converted, with amendments, by Law n. 116 of 11 August 2014.
[9] With the only exception of loan granted for the purchase of the first house according to which, in case of assessment, the borrower is liable for the taxes due (see article 20, paragraph 4, of Presidential decree 601/1973).
[10] Free translation.

In Italy, credit activity is governed by Legislative decree n. 385 of 1st September 1993 (the "Italian banking law")[11] and, under article 10 of such law, the activity of granting credit is reserved to "banks". Accordingly, Italian banks are regarded as qualifying lenders for the purpose of the application of the substitutive tax; *vice versa*, other financial institutions, even if duly authorized to exercise financing activity (such as leasing companies), could not qualify as persons eligible for the application of the substitutive tax[12]. Nevertheless, the Constitutional Court decision 242 dated 20 November 2017 held that financial intermediaries should not be discriminated, by denying them access to the substitutive tax regime in a lender capacity.

As far as non-resident lenders are concerned, under the wording of article 15 of Presidential decree 601/1973, for the application of the substitutive tax, the residence of the lender is not relevant per se. On the contrary, it is sufficient that the lender can be assimilated to an Italian bank. Under EU law, banks resident in a EU Member State are *de facto* assimilated to Italian banks and can operate directly in Italy with no restriction, even if without a branch located in Italy. By virtue of such assimilation with Italian banks, it is undisputed that article 15 applies with reference to loan granted by EU banks[13]. On the contrary, foreign banks established in non-EU Member States fall out of the scope of the substitutive tax regime because such banks cannot automatically be assimilated to "Italian banks". However, if a foreign non-EU bank operates in Italy by way of a permanent establishment, the Italian permanent establishment can apply the substitutive tax regime provided that such permanent establishment operates any banking activity duly authorized and regulated by the Bank of Italy *("Banca d'Italia")*.

Until the amendments introduced with Law decree 91/2014, apart from some other minor cases, the only exception to the above-mentioned principle was the possibility, set by article 2, paragraph, *1-bis*, of Law decree n. 220 of 3 August, 2004, to apply for the substitutive tax also by pension funds and other social security institutions with reference to loans granted to their employees or other registered members, for the sole purpose of the purchase of immovable properties.

Recently, Law decree 91/2014 introduced article 17-*bis* of Presidential decree 601/1973 which extended the possibility to apply for the substitutive tax also to loan agreements with a duration of more than 18 months granted by: i) Italian securitization companies *("società per la cartolarizzazione dei crediti")* as disciplined by Law n. 130, of 30 April 1999, ii) insurance companies that are incorporated and licensed under the laws of a Member State of the European Union ("EU Member State"), and iii) undertakings for collective investments (i.e. "investment funds") that are set up in a EU Member State or in a State pertaining to the European Economic Area ("EEA") included in the "white list"[14].

[11] "Testo unico delle Leggi in materia bancaria e creditizia".
[12] Among others, see ruling n. 61/E of 28 February 2002 and ruling 131/E of 10 June 2003, of the Italian tax administration and Circular letter n. 5/E of 8 may 2003 of the Italian territory agency.
[13] In this sense see Circular letter of the Italian tax administration n. 246/E-IV-8-869 of 8 October, 1996.
[14] See ministerial decree 4 September 1996 and following amendments.

The following table provides a list of resident and non-resident qualifying lenders.

	Legislative provision	Notes
Italian qualifying lenders		
Italian Banks	Art. 15 of Presidential decree 601/1973	Reference to article 10 of the Italian banking law
Italian pension funds and other social security institutions	Art. 2, paragraph 1-bis of Law decree 220/2004	With reference to loans granted to their employees or other registered members, for the purpose of the purchase of immovable properties
Italian securitization companies	Art. 17-*bis* of Presidential decree 601/1973	Securisations are disciplined by Law n. 130, of 30 April 1999
Italian insurance companies	Art. 17-*bis* of Presidential decree 601/1973	
Italian undertakings for collective investments	Art. 17-*bis* of Presidential decree 601/1973	
Italian financial intermediaries	Constitutional Court decision 242 dated 20 November 2017	
Non-resident qualifying lenders		
EU resident Banks	Art. 15 of Presidential decree 601/1973	See Circular 246/1996
Italian permanent establishment of non-EU Banks	Art. 15 of Presidential decree 601/1973	Provided the permanent establishment is authorized by the Bank of Italy
EU insurance companies	Art. 17-*bis* of Presidential decree 601/1973	
EU/EEA undertakings for collective investments	Art. 17-*bis* of Presidential decree 601/1973	

3. Subject matter requirement

The substitutive tax applies in principle with reference to medium and long term loan agreements, however, under article 16 of Presidential decree 601/1973, also loans granted to particular sector of activity and other loans as disciplined by special laws can benefit of the substitutive tax regime.

3.1. Medium-long-term loan agreements

According to the Italian jurisprudence, the "financing activity" that falls under the substitutive tax regime should be interpreted as the availability of capital to the borrower in any possible contractual form, irrespective of the technical characteristics of the facility itself. Banking loans *("mutuo bancario")* and advance credit facilities *("linee di credito")* fall under the scope of the substitutive tax. On the contrary, any other form of financing not providing the disbursement of funds, such as endorsement of credit *("credito di firma")* does not fall under the scope of the substitutive regime.

As far as the timing requirement is concerned, only medium and long term agreement fall under the scope of the Italian substitutive tax. By explicit provision of law medium and long term loans are those loans that lasts for more 18 months. In particular, Italian courts clarified that the provision must be interpreted in the sense that loans falling into the scope of the substitutive tax are those loans that last 18 months plus one day, therefore, the repayment of the loan must occur at least 18 months and 2 days after the loan was granted. Moreover, the Italian tax authority clarified that, in order to evaluate the length of the agreement, reference should be made to the exact termination date established in the agreement (i.e. looking at the contractual provision governing the reimbursement by the borrower), notwithstanding whether the "effective" duration of the agreement might be different because of subsequent negotiations or because factual circumstances occurred prior the end of the 18 months period. In this sense, loans with no termination date and loans with indefinite termination date, automatically fall out of the scope of the substitutive tax regime to the extent that the time requirement is not met. On the contrary, an early repayment of the loan does not *per se* prevent the application of the substitutive tax regime.

Due to the fact that the eighteen months threshold must be derived by the contractual obligation between the lender and the borrower, over the years it has been debated if clauses allowing for anticipated reimbursement, may prevent the application of the substitutive tax regime because the timing requirement was not met. The matter has been debated over the years and, in that regards the following guidelines have been provided.

In case of anticipated reimbursement clauses granted in favor of the lender, the Italian land administration with resolution n. 1/T of 24 February 2003, ruled that, if such clauses are mere *"cautelative"* clauses, according to which the lender can resolve the loan agreement only if certain legitimate circumstances for the safeguard of the credit are verified[15], the loan does not - *per se* - fall out of the scope the substitutive tax. On the contrary, in cases of clauses that allow the lender the possibility of an anticipated resolution not related to such particular, cautelative, measures but only to its personal evaluation over the condition of the borrower, the loan should not be considered eligible for the application of the substitutive tax.

In case of anticipated reimbursement clauses granted in favor of the borrower, the Italian land administration with circular n. 6/T of 14 June 2007, ruled that, within a legislative framework where the possibility of anticipated reimbursement by the borrower is granted by the law itself, agreements with clauses that allow the possibility of anticipated reimbursement by the borrower do not - *per se* - imply that the loans cannot benefit of the substitutive tax.

[15] As the clauses generally provided by Italian civil law.

3.2. Other loans and structured financing transactions

As previously indicated, apart from medium and long term loan agreements granted by financial institutions to whom article 15 of Presidential decree 601/1973 apply, also other specific forms of financing activities can benefit of the preferential regime of the substitutive tax.

In particular, under article 16 of Presidential decree 601/1973, loans granted to specific sectors of activity can benefit of the substitutive tax regime regardless of their maturity (i.e. even if they last for less than eighteen months).

According to article 19 of Presidential decree 601/1973, loan facilities granted with public funds or other loans prescribed by special laws (defined as "special loans"), fall under the scope of the substitutive tax, but are not computed in the taxable base of the substitutive tax (in simple terms such loans are not subject to the substitutive tax). In this case, even if they are excluded from the taxable base, the exemption from the other applicable indirect taxes applies.

Moreover, following the amendments introduced by Law decree 91/2014, under article 20-bis of Presidential decree 601/1973, it is now possible to elect for the application of the substitutive tax with reference to guarantees issued in relation to financing transactions carried out through the issuance of certain bonds or securities. In particular, article 20-bis provides that the bonds or similar securities issued can be underwritten by anyone; therefore, in these cases, the option may be exercised even if the loan is granted by a non-banking entity.

4. Territorial requirement

Article 20, paragraph 5, of Presidential decree 601/1973, states that, as far the assessment aspects of the substitutive tax are concerned, the provisions set for the registry tax should apply.

As far as territoriality is concerned, under article 2 of Presidential decree n. 131 of 26 April, 1986 (Presidential decree 131/1986), it is established that deeds are subject to registry tax (in Italy) in case they are formed in the territory of State, while deeds formed abroad are generally excluded from the Italian registry tax, except in case such deeds must be registered in Italy "in case of use"[16]. The only exception occurs when deeds formed abroad imply the transfer of immovable property or business located in Italy or the constitution or transfer of other rights, also guarantees, related to immovable properties or businesses located in Italy. In this last case, registry tax applies even in case of deeds formed abroad. Accordingly, the substitutive tax should apply following the same rules; therefore, loan agreements formed abroad by Italian borrowers and lenders are not subject to the substitutive tax in Italy (nor to any registry tax or stamp duty) unless they are secured with mortgage on Italian immovable properties. No relevance is attributed to the place of residence of the counterparts of the agreement, nor to the fact that the financing activity will be used for Italian investment or not.

The only element of connection with the territory of the State is represented by guarantees on immovable properties or on businesses (i.e. going concerns) located in Italy.

[16] In the event of a "caso d'uso", registration taxes would be payable either (i) upon filing of the receivable purchase agreement with any Italian Court that is called upon to decide on non-contentious matters or (ii) upon filing of the receivable purchase agreement with an Italian administrative authority or public body, unless the above-mentioned filing is compulsory as a matter of law.

The application of the territoriality rules to the substitutive tax on medium and long term loans has resulted in misleading interpretations by the Italian Tax Administration over the years, with particular reference to agreements formed abroad by Italian lenders.

The Italian Tax Administration, in fact, on the basis of the Italian anti-tax avoidance rules challenged taxpayers that formed deeds abroad contesting the absence of economic substance in such transactions, in order to obtain a favorable tax treatment. In this sense, with note of 24 April 2008 of the Regional division of Lombardy, the Italian tax administration envisaged the possibility of an hypothetical elusive practice, with reference to cases where the loan agreement was signed outside Italy between resident taxpayers, with the purpose of being used in Italy.

More recently, in 2013 with ruling n. 20/E of 28 March 2013, the Italian Tax Authority clarified that the place of the signing the contract does not fall within the concept of "abuse of rights". However, in the same ruling, the Italian tax administration focused on the notion of "conclusion of contracts" stating that the conclusion of a contract can be achieved even through term sheets which can show that the "formation of the consensus on the essential elements of the loan agreement" happened in Italy. Under the approach of the Italian tax administration, the substitutive tax should have also been applied to those contracts that, even if signed abroad, could still be considered as concluded in Italy since the consensus regarding their essential elements was reached therein.

Since the substitutive tax nowadays applies by election, the lender and the borrower no longer need to sign the contract abroad in order to escape it (when it is more burdensome than the taxes substituted); therefore, no more landmark rulings are expected on the territorial requirement.

Chapter 4

Financial Transaction Tax

Michele Gusmeroli | *Federico Traversa*

1. Introduction

The most important choice in designing a financial transaction tax is the territoriality system.

Three alternative criteria are available: (i) residence, (ii) market and (iii) issuer.

Under the residence criterion, resident entities (and permanent establishment of non-resident ones) are liable to tax on relevant transactions, wherever executed and whatever the issuer of the financial instruments traded. The drawback of this criterion is that - in a world where most countries do not adopt a financial transaction tax – financial intermediaries have an incentive to migrate from States with such an FTT to States without one.

Under the market criterion, both resident and non-resident entities are liable to tax on transactions carried on in the relevant markets, whatever the issuer of the financial instruments traded. The drawback of this criterion is that financial intermediaries have an incentive to trade in markets without an FTT rather than in markets with one.

Under the issuer criterion, transactions in shares issued by resident companies are taxed, wherever executed and whoever (whether resident or not) is carrying them on. This criterion has the advantage that if does not result in de-localization: companies migrate for other reasons that for the trading of their shares being subject to FTT; however, the drawback of this criterion is that it is difficult to enforce FTT over non-resident financial intermediaries trading in a foreign market.

Italian FTT is based on two different criteria:

- both (i) cash equities FTT and (ii) derivatives FTT (which together derive pretty much all the tax revenues) are based on the issuance principle: the difference is that (i) cash equities FTT is based on the issuer of the shares, whilst (ii) derivatives FTT is based on the issuer of the underlying shares (as the issuer of the derivative itself does not matter);
- high-frequency trading FTT is based on the market criterion: both resident and non-resident financial intermediaries are liable to this tax when trading shares in the Italian stock market (irrespective of the issuer of such shares).

Article 1 (Definitions) of the FTT decree[1] provides that the scope of the cash equities tax includes shares of most companies incorporated under Italian law, irrespective of their residence for direct tax purposes[2].

This makes sense: the management of a company can take a position on its direct tax residence when signing the corporate income tax return in the following year; a trader cannot take such a position when buying the stock during the year.

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1 This article shall follow the FTT decree (dated 21 February 2013, as amended by decree 16 September 2013), rather than the relevant piece of legislation (law 24 December 2012, n. 228, paragraphs 491-500): the latter is extremely general and market practice is to make reference to the decree as the fundamental provision in FTT matters.

2 Shares are defined as stocks of companies belonging to one of the following types, even if falling into a special category, and regardless of the assignment of certain administrative or property rights: companies under Italian law .

This also means that an Italian company, which wanted to avoid FTT on the trading of its shares, could simply transfer the seat abroad (e.g. in the Netherlands), maintaining in Italy the place of effective management, to which direct tax residence is usually attached: this way, direct tax residence would be maintained and no exit tax issues would be triggered.

Italian FTT also targets (i) participating financial instruments and (ii) securities representing equity investment. The former are financial instruments issued by Italian companies, which assign certain administrative and property rights against contributions by shareholders or third parties, resulting in any form of participation of the stakeholder to the performance of the company or of some of its branches of business. The latter are depositary receipts in respect of shares and other certificates representing shares or participating instruments, issued by companies resident in the Italian territory: most notably ADRs whose underlying is a share issued by an Italian company; the issuer criterion here targets the underlying shares, rather than the issuer of the financial instruments (derivatives FTT also works this way).

2. Cash equities FTT

2.1. Objective scope

Article 2 provides that cash equities FTT applies to the transfers of ownership of the above-mentioned securities and other financial instruments issued by companies resident in the State territory. As already mentioned, residence is determined on the basis of the registered office. Additionally, the tax shall apply to the transfer of the ownership of securities representing equity investment, regardless of the place of residence of the issuer of the certificate and of the place where the contract has been concluded.

The transfers of the ownership of shares or units in collective investment vehicles ("OICR" in Italy), including the shares of open-ended investment companies, is excluded from the scope of the tax.

2.2. Transfer of ownership

Article 3 provides that the tax is triggered by the transfer of ownership of shares issued by companies incorporated in Italy. Primary market transactions (i.e. contributions and redemptions) are out of scope, in the sense that the issuance of new shares and the redemption of existing shares are not taxable; however, this exclusion does not extend to the consideration for the primary market transaction.

The "transfer of ownership" concept should be interpreted broadly: it is not limited to a sale for consideration (as it can also take place for no consideration) and does not need to be voluntary. The circumstance that inheritance and gift transactions are explicitly scoped out under Article 15(1)(a) of the decree implies that, without such an exclusion, they would have been taxable as a transfer of ownership.

As far as timing is concerned, a distinction should be made between (i) trade date and (ii) settlement date. The former takes place when a contract is concluded (e.g. we agree that I buy and you sell 100 shares for 1.5€ each); the latter when contractual duties are fulfilled (e.g. I deliver you 150€ and you deliver me the 100 shares).

known as "società per azioni", "società in accomandita per azioni" and European companies referred to in Regulation (EC)No 2157/2001, as well as companies under Italian law known as "società cooperative" and "mutue assicuratrici", unless the articles of incorporation stipulate that the laws for companies under Italian law known as "società a responsabilità limitata" under Article 2519(2), of the Italian Civil Code, should apply. Società a Responsabilità Limitata is out of scope.

Most financial markets work "on a t+2 basis": this means that settlement date is usually two working days after trade date. Italian FTT is based on the settlement date.

For transactions carried on outside financial markets, the transfer of ownership takes place when the legal effect is produced. Transfers resulting from the conversion of bonds into shares, as well transfers arising from the exchange or the refund of bonds with shares or other participating financial instruments are also considered as transfers of ownership of shares or other participating financial instruments: the transfer of ownership takes place on the date the conversion, exchange or refund have effect.

2.3. Value of the transaction

Financial markets operate the settlement on a net basis: if I purchase 100 shares of a company and then sell 80 of those shares, I am only being delivered 20 shares. This requires that the trade settle on the same date (otherwise, there would be a mismatch between the purchase and the sale), but the trade dates might be different. E.g. I purchase the 100 shares on a market settling on a t+3 basis and - the following day - I sell 80 of those shares on a market settling on a t+2 basis: as the trades settle on the same date, I am only delivered the net amount of shares.

Financial transaction tax systems must choose whether to tax the gross (i.e. the 100 shares) or the net amount (i.e. the 20 shares). In this respect, Italy followed the French example, choosing to operate cash equities FTT on a netting basis.

Article 4 indeed provides that the value of the transaction is determined on the basis of the net balance of the transactions regulated daily, calculated for each liable person with reference to the number of securities settled on the same day and relating to the same financial instrument. This means that netting is allowed, provided that all of the following requirements are met:

(i) same taxpayer,

(ii) same settlement date,

(iii) same financial instrument.

The law does not provide for a fourth requirement: (iv) same intermediary. However, this requirement is somewhat implied in the mechanics of netting: as a matter of fact, each intermediary settles its own trades. E.g. if I buy 100 shares with one intermediary and sell 80 of the same shares with another intermediary, then I am delivered the 100 shares by the first intermediary (over which I pay the tax) and I deliver the 80 shares to the other one. This way, I end up paying FTT over 100 rather than over 20.

In order to tackle this issue, Article 4(4) of the FTT decree provides that netting may also take place across intermediaries. Two models of "broker pooling" are envisaged: in the first, the taxpayer designates one of the brokers as a pooler; in the second, the central securities depository acts as pooler for all the brokers. The issue with the first model is that the other brokers should provide the pooler with the net data relating the client: apart from involving substantial investment in having the brokers' IT systems communicating with each other, this would mean disclosing valuable client information to your competitors (something brokers loathe). Unsurprisingly, the FTT decree provides that the brokers are under no duty to accept the client request: the authors have no knowledge of a broker ever having been available to operate under the broker-pooler model. The second model, on the other hand,

looked less dangerous in terms of client information disclosure: as the pooler was supposed to be Montetitoli (central securities depository), such information would not have gone to competitors and so the brokers might have been willing to operate. However, Montetitoli is not offering this service and so netting-conscious taxpayers stick to one broker.

2.4. Taxable person

Article 5 provides that the tax is payable by the purchaser. Cash equities FTT only taxes the purchase leg of a transaction; the sale leg is not taxable. Derivatives FTT, on the other hand, taxes both legs.

In financial markets, most transactions do not involve simply a buyer and a seller: they involve (at least) the seller, the seller's broker, the buyer's broker and, eventually, the buyer. Multiple layers of intermediaries are involved, which (depending on the market) may operate either on an (i) agency or on a (ii) riskless principal basis. Brokers operating on an agency basis typically deal under their own name, but on behalf of another person (i.e. the client). Brokers operating on a riskless principal basis typically deal under their own name and for their own account (in this respect, they are principal rather than agents), but they have a matching trade with the client, which clears their position (in this respect, they are riskless, as they take no exposure to the stock).

In the even FTT applied to each and every link in the transaction chain, this would cause one transaction to be taxed multiple times: this is known as the "cascading effect". FTT on the sale from the selling client to its broker, FTT on the sale from the seller's broker to the buyer's one and FTT on the sale from the buyer's broker to the buyer client. This would multiply the tax and cause concentration in the brokerage industry: since there would be no tax in the event the buyer's broker and the seller's one were the same entity, huge brokerage houses (more likely to find themselves at both sides of a trade) would operate at an advantage to smaller ones (which due to their size would be less likely to operate on both sides).

In order to avoid the cascading effect and its drawbacks, Italian FTT provides for two sets of rules, depending on the model the brokers are operating.

Article 3(4) of the FTT decree targets brokers operating on an agency model. Transfers made through intermediaries buying in their name but on behalf of another person are deemed as transfers of property only with regard to the person on behalf of whom the transfer has been made. Back to the situation where we have the seller, the seller's broker, the buyer's broker and, eventually, the buyer: in the event both the seller's and the buyer's broker are operating on an agency model, then we would only see a purchase from the client as the only taxable transaction, as the passages to the brokers would not be relevant.

The riskless principal model is provided for by a dual set of rules:

- Article 15(2)(a) of the FTT decree states the intermediary purchase on the market is not taxable (only the client purchase from the intermediary is);
- Article 6(1) last sentence of the FTT decree states the client purchase from the intermediary is taxable with the reduced market rate of 10bp (rather than with the OTC rate of 20bp).

The above provisions work to the extent their 3 requirements are jointly met, which are: (i) same price, (ii) same overall quantity and (iii) same settlement date.

2.5. Tax rate

Article 6 provides that the cash equities FTT rate is 0.2% (i.e. 20 basis points), but it is halved to 0.1% (i.e. 10 basis points) for transfers following transactions traded in regulated markets and multilateral trading facilities. Regulated markets and multilateral trading facilities are defined under Article 1(2)(f)[3].

This is the reason why the riskless principal set of rules (see previous paragraph) has two prongs. Article 15(2)(a) provides that the intermediary purchase on the market is not taxable and Article 6(1) last sentence provides that the client purchase from the intermediary is taxable with the reduced market rate of 10bp (rather than with the OTC rate of 20bp). Without the second part, the client purchase from the intermediary (an OTC trade) would not have been entitled to the reduced market rate.

As already mentioned, there are three requirements (all of which to be met) for the riskless principal rules to apply: (i) same price, (ii) same overall quantity and (iii) same settlement date. This created some issues

Effective 6 October 2014, Borsa Italiana made a landmark switch from a t+3 to a t+2 settlement system; consequently, on Wednesday 8 October they settled both Friday 3 October trades (last on a t+3 basis) and Monday 6 October trades (first on a t+2 basis). A few brokers had issues, to the extent they either did not notice the change or anyway (maybe due to legal or IT issues) they were keeping t+3 as their settlement with the client: as a result, riskless principal status was jeopardized, as client leg and market leg no longer settled on the same date. As a result thereof:

- both client leg and market leg transactions became taxable (and no netting was available, since that also requires settlement on the same date);
- the client leg was taxable at 20bp rather than at 10 bp.

3. Derivatives FTT

3.1. Objective scope

Article 7(1) provides that derivatives FTT applies to transactions on:

- derivatives whose underlying is mainly one or more securities taxable under the cash equity FTT;
- derivatives whose value depends mainly on one or more securities taxable under the cash equity FTT;
- transactions on any other security, allowing to purchase or sale securities taxable under the cash equity FTT (equity-settled derivatives, including warrants, covered warrants, and certificates);

3 Regulated markets and multilateral trading facilities are the markets and systems acknowledged under Directive 2004/39/EC of 21 April 2004, relevant to the Economic European Area, as included in the list published in the specific section of the European Securities and Markets Authority' website (http://mifiddatabase.esma.europa.eu/) for the purposes provided for in paragraph 2 of Article 13 of (EC) Regulation No 1287/2006 of the Commission, of 10 August 2006, provided that they are established in States and territories included in the Italian white list (http://www.agenziaentrate.gov.it/wps/content/Nsilib/Nsi/Documentazione/Fiscalita+internazionale/White+list+e+Autocertificazione/Elenco). In the case of the States to which the aforesaid provisions do not apply, regulated markets and multilateral trading facilities are considered those in regular operation and authorized by a National Public Authority with State supervision, including therein those recognized by CONSOB under Article 67(2), of the Italian Finance Code, provided that they are established in States and territories included in the above white list.

- transactions on any other transferable security involving a cash payment determined with reference to securities taxable under the cash equity FTT (cash-settled derivatives, including warrants, covered warrants, and certificates.

3.2. Taxable event

Under Article 8 of the Decree, transactions in derivative financial instruments and transferable securities are subject to tax at the time of entry into the contract.

This is to be understood, respectively, as the time of subscription, negotiation or modification of the contract and as the time of transfer of ownership of such transferable securities.

The term "modification of the contract" shall mean a variation of its notional value, parties, maturity, underlying or reference value. In this case, changes in underlying or reference value not decided by the parties are not considered as modifications of the contract, provided that the contract was already subject to FTT.

In case the parties are modified, the tax is due by both the old and the new party.

Where the notional value is modified upward or downward, not depending on a variation of the underlying or reference value, the tax shall be applied only to the variation of the notional value.

3.3. Taxable amount

The taxable amount is defined as the "notional value". Article 9 provides for different criteria in order to determine the notional value, which are based on the kind of derivative.

In particular, the notional value should be determined as follow:

1. for stock index futures traded on regulated markets or in multilateral trading facilities, the number of standard contracts multiplied by the number of index points under which the contract is traded by the value assigned to the index point;
2. for single stock futures traded on regulated markets or multilateral trading facilities, the number of standard contracts multiplied by the price of the futures by the standard contract size;
3. for stock index options traded on regulated markets or in multilateral trading facilities, the number of standard contracts multiplied by the contract price (premium) expressed in index points multiplied by the value assigned to the index point;
4. for stock options traded on regulated markets or in multilateral trading facilities, the number of standard contracts multiplied by the contract price (premium) multiplied by the standard contract size;
5. for other options, the price (premium) paid or received for entering into the contract;
6. for forward contracts, where the underlying is - even indirectly - an index, the product of the forward unit value of the index and the number of units of the index under the contract; where the underlying are (even indirectly) shares, the number of shares multiplied by the forward price;
7. for swap contracts, the amount according to which the swap flows are determined (even indirectly) recognized upon conclusion of the transaction;
8. for financial contracts for difference, the value of the index or shares on which the contract's profits or losses (even indirectly) depend;
9. for warrants, the number of warrants purchased, subscribed or sold multiplied by the purchase or selling price;

10. for covered warrants, the number of covered warrants purchased or sold multiplied by the purchase or selling price;
11. for certificates, the number of certificates purchased or sold multiplied by the purchase or selling price;
12. for securities giving rise to a cash settlement determined by reference to shares and related yields, indices or measurements, the amount according to which cash flows or maturity profile or economic result of the transaction are determined, calculated at the time of purchase and sale of securities;
13. for combinations of the above contracts or securities, the sum of the notional amounts of contracts and securities within the contract or security in question.

3.4. Taxable persons

Article 10 provides that all parties in a derivative trade are liable to the tax, with the rates under Article 11: this means that the total tax burden will often be twice those rates. While cash equities FTT only taxes the purchase leg of a transaction, derivatives FTT taxes both legs.

3.5. Amount of the tax

Article 11 provides that the derivative FTT is a fixed amount determined as set out in the below table (where notional value is expressed in thousands of Euro, while the due tax is expressed in Euro) based on the type of derivative and notional value.

Derivative contract	**Notional value (thousands of Euro)**							
	0-2.5	2.5-5	5-10	10-50	50-100	100-500	500-1000	>1000
Futures, certificates, covered warrants and options on yield, index or measures relating to shares	0.01875	0.0375	0.075	0.375	0.75	3.75	7.5	15
Futures, certificates, warrants, covered warrants and options on shares	0.125	0.25	0.5	2.5	5	25	50	100
Other Derivatives: • Swaps on shares and related yield, index or measures • Forward contracts on shares and related yield, index or measures • Financial contracts for differences on shares and related yield, index or measures • Any other securities which provides for cash settlement determined in connection with shares and related yield, index or measures • Combinations of the contracts and securities above	0.25	0.5	1	5	10	50	100	200

The rate is reduced to 20% (i.e. one fifth) of the above for transactions carried on in regulated markets and in multilateral exchange systems.

If a derivative is equity-settled, the consequent share transaction is ordinarily subject to FTT; in other words, the derivative transaction FTT is cumulative with (and not alternative to) the share transaction FTT.

4. High-frequency trading FTT

4.1. Subject matter scope

Article 12 implements section 495 of the law, which provides for a 0.02% tax on high-frequency trading transactions. These are measured by way of purchase or sale orders, which are amended or cancelled by an algorithm within half a second from inception.

From a subject matter point of view, in scope are (a) the securities subject to cash equities FTT (i.e. the above-mentioned shares, participating financial instruments and securities representing equity investment) and (b) the securities subject to derivatives FTT (i.e. the above-mentioned derivative financial instruments and transferable securities). These latter must still have the former as their main underlying or reference value. However, the issuer is not relevant: neither the issuer of the securities under (a), nor the issuer of those under (b), not that of the underlying securities thereof.

In January 2015, an FAQ document was released by the Italian Ministry of Finance. FAQ number 3 is of paramount importance in this respect:

3) Q: Please clarify the markets and securities which the tax on high-frequency trading referred to in paragraph 495 applies to.

A: As provided by Article 12 of the Decree, the tax on high-frequency trading referred to in paragraph 495 applies to the transactions in financial instruments referred to in paragraphs 491 and 492, even if not issued by Italian resident companies, provided they take place on Italian regulated markets and multilateral trading facilities. Therefore, the transactions in securities of the companies referred to in Article 17 of the Decree (listed companies with average capitalization of less that 500 million) and the transactions in derivative financial instruments and securities referred to in paragraph 492, even if the underlying is not represented by securities issued by Italian resident companies, are subject to the tax on high frequency trading.

This FAQ document is extremely useful in understanding that Italian FTT is based on two different territoriality criteria:

- both (i) cash equities FTT and (ii) derivatives FTT (which together derive pretty much all the tax revenues) are based on the issuer principle: the difference is that (i) cash equities FTT is based on the issuer of the shares, whilst (ii) derivatives FTT is based on the issuer of the underlying shares (as the issuer of the derivative itself does not matter);
- high-frequency trading FTT is based on the market principle: both resident and non-resident financial intermediaries are liable to this tax when trading shares and share-based derivatives in the Italian stock market (irrespective of the issuer of such shares and of the issuer of the shares underlying the derivatives).

As a consequence of the above, there are discrepancies in the scope of the two set of taxes:
- trading in an Italian share in a foreign stock market will trigger cash equities FTT, but not HFT;
- trading in a foreign share in the Italian stock market will not trigger cash equities FTT, but will be liable to HFT.

With specific reference to derivatives, reference should be made to the underlying securities to which these are predominantly correlated: unlike with derivatives FTT (where the underlying shares had to be issued by Italian companies), with HFT the issuer of the underlying shares no longer matters and so the scope of taxable financial instruments is considerably broader.

Exemptions are provided for (i) market making activities (see paragraph 5.2 below) and (ii) best execution requirements.

4.2. Application of the tax

Article 13 provides that the tax is calculated on a daily basis and is payable where – in a single trading day - the ratio between the sum of cancelled orders and modified orders, and the sum of orders entered and orders modified exceeds 60 per cent, with reference to the single financial instruments. For this purpose, only the orders cancelled or modified within half a second are taken into consideration, as defined in Article 12. The tax applies, for each trading day, on the value of the cancelled and modified orders exceeding the 60 per cent threshold.

4.3. Taxable person

Article 14 provides that the taxpayer is directly liable to tax. The taxpayer is defined as the person that, by means of the above-mentioned algorithms, enters both (i) purchase and sale orders and (ii) the related modifications and cancellations.

5. Exclusions and exemptions

5.1. Exclusions

Article 15 provides that several transactions are excluded from the FTT scope.

Some exclusions concern the nature of the transfer: under Article 15(1)(a), inheritance and gifts are not considered as taxable transactions.

Other exclusions are focused on the subject matter, such as the one for bonds and debt securities under Article 15(1)(b). Since only shares and derivatives are in scope, one could be wondering whether there was a need to exclude securities that were never in scope to start with. Actually, certain bonds do embed a share-based derivative (e.g. a convertible is a bond cum call option) and – in the absence of an exclusion – they would have been subject to derivatives FTT. This is the reason why an explicit exclusion is needed for bonds and debt securities. However, the exclusion was quickly exploited, since you only had to package a share-based derivative into a debt security, in order for the exclusion to apply. This is the reason why the provision was narrowed and now it only applies to debt securities with an unconditional obligation to repay at maturity an amount no lower than face value. Furthermore, Article 15(1)(b-bis) excludes transactions involving bonds and debt securities, issued by intermediaries subject to the supervision of the Bank of Italy or IVASS (insurance sector supervisor), that are relevant for capital adequacy purposes under EU law and national prudential regulations

(e.g. perpetual bonds).

Primary market transactions are also excluded under Article 15(1)(c). These are defined not merely as issues and redemptions of shares, but also include the repurchases of securities by the issuer, to the extent such repurchases aim to the cancellation of the traded securities. As far as partial redemptions are concerned, the FTT exclusion only applies to transactions in which the issuer repurchases the securities for the subsequent cancellation thereof; on the other hand, FTT applies when a third party purchases the securities of the outgoing shareholder. The purchase of own shares is only excluded if aimed at the cancellation of the shares: if the cancellation is decided after the purchase of own shares, the purchase is subject to tax because when it was performed it was not aimed at the cancellation of shares.

The issue of new shares is always excluded under Article 15(1)(d), also when related (i) to conversion, exchange or refund of bonds or (ii) in case of exercise of underwriting rights. As far as corporate actions are concerned, the explanatory memorandum specifically indicates that the distribution of profits or reserves through the allocation of shares, even if not newly issued ones (e.g. own shares in portfolio by the issuer) is anyway excluded from tax. This is due to the fact that the election as to the collection method of profits and/or reserves is not left to the taxpayer's choice.

Article 15(1)(e) provides another exemption for transfers of ownership of cash equities related to financing transactions, as a result of lending/borrowing or repurchase/reverse repurchase transaction, or a buy-sell back or sell-buy back transaction; the exclusion also extends to collateral transactions. However, FTT applies in the event the transfer of ownership becomes final, e.g. when the collateral is enforced.

Article 15(1)(f) provides for the "small caps" exclusion: their transfer is exempted both when taking place on a regulated market and OTC. Reference is made to paragraph 5.3 for the small caps definition.

Under Article 15(1)(g) of the FTT decree, no tax applies to the transfer of the ownership of Italian shares (and derivatives) effected by companies which are in a control relationship under Article 2359(1)(1), 2359(1)(2) and 2359(2) of the Civil Code, or which are controlled by the same company. The scope of the intragroup exclusion was somehow broadened by the interpretation under the 2013 FAQ guidance. The Ministry of Finance was asked to clarify whether the exclusion under Article 15(1)(g) may also apply to transactions between unit trusts between which there was a control link similar to that provided for by Article 2359 of the Civil Code. The Ministry held that "Article 15(1)(g) also applies to unit trusts that are not in corporate form, also with a view to avoid discrimination between fondi costituiti come patrimonio autonomo (funds with equities raised independently) and SICAVs (investment companies with variable capital)". Apparently, the rationale behind the provision is that of exempting transactions between an entity and its largest stakeholder: as the FAQ makes clear, any discrimination between incorporated and unincorporated funds must be avoided and the reference to Article 2359 must be interpreted widely.

Under Article 15(1)(h) of the decree, no FTT applies to the transfer of ownership of Italian shares, or the change of ownership of derivatives, arising from (a) restructuring operations under Article 4 of Council Directive 2008/7/EC of 12 February 2008, as well as (b) mergers and divisions of collective investment undertakings. The restructuring operations defined by Article 4 comprise two types of mergers: (i) mergers effected by contribution of assets, and (ii) mergers effected by exchange of shares: in both cases, the consideration should consists at least in part of securities representing the capital of the acquiring company. There

is no definition as to which transactions should be considered as "mergers and divisions of collective investment undertakings"; the provision should be analyzed from a textual point of view, meaning that (i) the transaction should be similar to a merger or a division under Italian law and (ii) both entities involved should qualify as collective investment undertakings (as the Italian definition is patterned after the AIFMD, any fund meeting such definition should qualify).

Article 15(1)(i) provides that (i) participating financial instruments issued by companies whose shares are considered as small caps and (ii) securities representing equity investments in small caps are also excluded from the FTT scope. Again, reference is made to paragraph 5.3 for the small caps definition.

Article 15(2)(a) provides for the riskless principal exclusion, for which reference is made to the previous paragraphs 2.4 and 2.5.

Article 15(2)(b) excludes central clearing counterparts under EU Regulation 648/2012 of 4 July 2012; for those countries where the above Regulation is not in force, reference is made to equivalent foreign systems which are authorized and supervised by a national public authority.

5.2. Exemptions

Article 16 provides for several exemptions from the application of FTT. The difference between exclusions and exemptions is that the former is a scope limitation, while the latter is a derogation for transactions that would otherwise be in scope; in practical terms, exemptions must be interpreted narrowly.

Article 16(1)(a) exempts certain transactions on the basis of the personal status of a counterpart: (i) the European Union or the European institutions, the European Atomic Energy Community; (ii) the bodies covered by the Protocol on the Privileges and Immunities of the European Union or the European Central Bank and the European Investment Bank; (iii) the central banks of the Member States of the European Union and the central banks and organizations managing also the official reserves of other States (quite important, as most Sovereign Wealth Funds fall within this item); (iv) bodies or international organizations established in accordance with international agreements enforced in Italy.

Article 16(1)(b) and (c) are an empty provision. The law provided for an exemption for ethical and socially responsible mutual funds and portfolios, but such an exemption aborted in the decree. The way it is worded, it exempts the transfer of units in the above funds (in fact, fund units are generally out of the scope) and the underwriting of the above contracts (in fact, this is not a taxable transaction). As the Ministry of Finance acknowledged in a subsequent FAQ document, this means that ethical and socially responsible mutual funds and portfolios enjoy no exemption when performing a taxable transaction.

Article 16(2) highlight that all the exemptions under Article 16(1) are not merely personal, but also extend to the counterpart in a relevant transaction. E.g. an otherwise taxable person is also exempted if purchasing a taxable participation from an eligible Sovereign Wealth Fund.

Article 16(3)(a) is perhaps the most debated provision of all the decree: the market making exemption. Market making is defined by way of a regulatory reference to Article 2(1)(k) of EU regulation 236/2012 of 14 March 2012 on short selling and certain aspects of credit default swaps. This defines 'market making activities' as the activities of a financial intermediary, which is a member of a trading venue where it deals as principal in a financial instrument, whether traded on or outside a trading venue, in any of the following capacities: (i) by posting

firm, simultaneous two-way quotes of comparable size and at competitive prices, with the result of providing liquidity on a regular and ongoing basis to the market; (ii) as part of its usual business, by fulfilling orders initiated by clients or in response to clients' requests to trade; (iii) by hedging positions arising from the fulfilment of tasks under points (i) and (ii). Several requirements must be met. From a personal point of view, the financial intermediary must qualify as an investment firm, a credit institution, a third-country entity, or a firm as referred to in point (l) of Article 2(1) of Directive 2004/39/EC. As clarified by the ESMA guidelines, this intermediary must then (a) be a member of the market on which it (b) deals as principal (c) in the financial instrument for which it notifies the exemption. Consequently, no market making exemption is available with respect to unlisted securities – and this also extends to any hedging trades; e.g. the purchase of listed shares is not exempted, when it is performed in order to hedge an imbalance derived from trading an OTC (over-the-counter) derivative.

Article 16(3)(b) exempts liquidity providers under Directive 2003/6/EC of 20 January 2003 and Directive 2004/72/EC of 29 April 2004; in order to benefit from this exemption, a direct contract is required with the security issuer.

Article 16(4) provides that the exemptions under 16(3) are limited twice: on the one hand, they only apply to the relevant persons (differently from the personal exemptions above); on the other hand, they only apply limited to the relevant activities. Consequently, the counterpart to a market making transaction may not enjoy the exemption; moreover, an intermediary acting as a market maker with reference to certain securities is otherwise subject to tax when trading other securities, for which it is not registered as a market maker.

Article 16(5) exempts pension funds supervised under Directive 2003/41/EC and compulsory social security institutions, established in the EU and the EEA, as well as other supplementary pension schemes. The requirement that pension funds be supervised under an EU directive means that non-EU pension funds are not eligible for this exemption. Most notably, the decree explicitly provides that pension funds are exempted not only when investing directly, but also when investing indirectly via pension fund pooling vehicles (to the extent such vehicles are fully owned by eligible pension funds).

Some exemptions are not provided in the text of the FTT decree, but they are envisaged (i) in the ministerial report to such decree or (ii) in subsequent FAQs (frequently asked questions) documents. Market practice is to rely on these exemptions, despite their not having gone through a proper legislative approval process. Exchange Traded Funds (hereinafter, "ETFs") are index funds whose units are traded in regulated markets: investors therefore buy and sell units in the secondary market against other investors, rather than having the units issued and redeemed by the fund. The primary market is reserved to creation agents, arbitrages institutional investors that (a) purchase on the market the underlying shares and contribute them into the ETF in exchange for the issuance of new ETF units they sell on the market and (b) purchase on the market ETF units and redeem them against the underlying shares which they then sell on the market. In the absence of a specific exemption, there would be a double FTT charge on both transactions: (a)(i) the creation agent would be subject to FTT on the market purchase of the shares and (a)(ii) the ETF would be subject to FTT on receiving the same shares as a contribution; (b)(i) the creation agent would be subject to FTT on receiving the shares in redemption for ETF units and (b)(ii) FTT would apply to the purchasers when the creation agent sells the shares on the market. This is the reason why the ministerial report provided for an ad hoc exemption, by stating that in cases of issuance of ETF units against the

simultaneous contribution of shares or other participating financial instruments or securities representing equity investment, the tax is not payable by the ETF, but only by the person purchasing the shares or the other participating instruments or securities representing equity investment in order to contribute them in the ETF. The exemption was then clarified by a Ministry of Finance FAQ: in the case of ETF creation in kind, the tax is due by the person (creation agent) purchasing the shares (or participating instruments) in order to contribute them in the ETF. In case of redemption in kind, the same procedure as creation in kind applies: only the sale of shares on the market by the creation agent is subject to tax. Therefore, no FTT applies to the creation / redemption in kind process of ETFs.

5.3. Small caps

Article 17 defines "small caps", which are excluded under Article 15(1)(f) and (i): they are defined as companies listed (in Italian or foreign regulated markets), with an average market capitalization lower than 500 million euro. The market capitalization is determined with reference to November of the previous year and companies satisfying this requirement are published in a specific list of the Ministry of Finance, which is published in December and is valid for the following calendar year.

Newly listed companies are presumed as not exceeding the 500 million euro threshold, until they make (or do not make) the following list. Even if their capitalization is much higher, their shares are not subject to FTT until the end of the year in which they were listed; in fact, if the listing takes place in December, then the exemption can last for 13 months. This deeming provision is quite important, as it effectively results in all IPOs being excluded from FTT.

6. Procedural rules

6.1. Liable party

First level intermediaries are always responsible for FTT. They are:
- Italian banks,
- Italian investment companies and
- Other entities (whether Italian or foreign) authorized in their State of establishment to undertake activities akin to those under Articles 1(5)(a) ("proprietary trading"), 1(5)(b) ("executing clients' orders") and 1(5)(e) ("receiving and transmitting orders") of the Italian Finance Code, with the exclusion of matching two or more investors.

Second level intermediaries are responsible for FTT only under certain circumstances. They are:
- Asset management companies, including entities (whether Italian or foreign) authorized in their State of establishment to undertake activities akin to those under Articles 1(5)(g) ("portfolio management") and 1(1)(n) ("management of mutual savings") of the Italian Finance Code, for transactions in the scope of such activities, unless a first class intermediary is carrying out the transaction orders on their behalf;
- Trust companies (whether Italian or foreign), for transactions in their own name and on behalf of beneficiaries, unless a first class intermediary is carrying out the transaction orders on their behalf, or the beneficiary represents that Italian FTT was already applied;
- Notary publics and other persons drafting or legalizing deeds, whether in Italy or abroad, unless the taxpayer represents that Italian FTT was already applied.

In the event neither a first nor a second level intermediary is involved, then the taxpayer is liable for his own FTT.

6.2. Application of the tax

As a rule, FTT is applied by the "first level" intermediary, when intervening in the relevant transaction; if no "first level" intermediary is involved, then a "second level" intermediary applies the tax.

Under Article 19(4) of the Implementation Decree dated February 21, 2013 (the "Decree"), the "chain of intermediaries" rule is provided, under which:

- if several intermediaries are involved in the execution of a transaction, the tax is paid by the intermediary who directly receives the order to execute the transaction from the final purchaser / subscriber;
- if an intermediary is located in a "black list" Country, the tax is levied by the "white list" intermediary receiving the purchase / subscription order (i.e. the "black list" intermediary is considered as final purchaser / subscriber). However, also the "black list" intermediary should be required to apply the tax and then request for the refund of the tax paid twice.

To this extent, the distinction between "first level" and "second level" intermediaries is important: only "first level" intermediaries fall within the scope of the "chain of intermediaries" rule, while "second level" intermediaries are only liable on a residual basis (i.e. if no "first level" intermediaries are involved in the chain), so that there is no scope for them to be liable for FTT in a chain of intermediaries.

6.3. Payment of the tax

FTT is paid within the 16th of the month following the one in which the transaction was carried out.

The tax balance should be calculated on a monthly basis, with reference to transactions carried out the previous month (e.g. October transactions trigger an FTT payable by November 16).

As far as the payment of the tax is concerned, if the foreign intermediary has an Italian permanent establishment ("PE"), then such PE is (mandatory) responsible for the payment of the tax for transactions wherever carried out by the Head Quarter and by any of its PEs.

Lacking an Italian PE, the tax should be paid:

- directly to the Italian tax authorities through F24 form (if the intermediary has an Italian current account) or trough a specific bank transfer (only if the intermediary does not have an Italian current account); or
- by the Italian tax representative opportunely appointed by the foreign intermediary. To this extent, "black list" intermediaries can also appoint their PE in a "white list" country (if any) in order to handle the payment of the tax; or
- by Monte Titoli (Italian centralized share management company). To this extent it is required that the foreign intermediary provides Monte Titoli with (i) a specific proxy and (ii) the necessary funding within the payment deadline.

6.4. Recordkeeping

Under paragraph 5 of the Provision 87896 dated 18 July 2013 and under Provision 47944 dated 9 March 2017 (the "Provisions"), financial intermediaries which are responsible for the payment of the tax are also required to fulfill specific instrumental obligations.

Instrumental obligations consist in establishing a specific register in which are recorded information related to each transaction relevant for FTT purposes, in accordance to the

technical standards provided by the annexes to the Provision.

In particular, such registrations should be:

- stored in a data warehouse electronically kept, where the related information are retained in a centralized manner, also organized in sectional tables. The register should be kept in such a way allowing the storage of the daily chronological order of the transactions, the immutability and the preservation of registered data;
- carried out within the deadline established for the payment of the tax;
- retained at least for ten years.

Furthermore, if the foreign intermediary has an Italian PE, then the register should be kept and set up by such PE (with the information provided by the Head Quarter) in an electronic register set up under to the provisions of the Digital Administration Code, referred to in the Legislative Decree no. 82 dated March 7, 2005. Registrations relate to the transactions it carried out, as well as information of the transactions carried out by its Head Quarter (and each PEs of the Head Quarter).

If the foreign intermediary appointed a fiscal representative for IFTT purposes, then the register should be solely kept by the fiscal representative, while the responsible for registrations remains the foreign intermediary.

Finally, if the foreign intermediary delegated Monte Titoli for the payment of the tax, then it should provide Monte Titoli, on a monthly basis and within the 5th working day of the following month after the execution of the transaction, with information related to the transactions relevant for IFTT purposes, according to the specifications and the track record attached to the Provision.

The tax Authorities, pending an audit activity, may require to provide all or a portion of the data stored in the mentioned registers.

Chapter 5

Interaction with the Tax Authority

Carlo Romano | Rubina Fagioli

Italian tax law, and especially those provisions concerned with tax disputes and controversies, have recently undergone a major reform process, which might not have concluded yet. A general preference to a pre-emptive approach is the overarching theme of the newly enacted amendments, aiming to solve most of the issues before the tax obligations are fulfilled. Alternatively, another underlying principle of the reform is the recast of the existent legislation, fragmented in episodic laws and decrees, with cross references and provisions sometimes difficult to coordinate and reconcile for any interpreter.

1. The cooperative compliance regime

The cooperative compliance regime, initially launched as a pilot project in 2013, was introduced by decree-law no. 128 of 2015 with the purpose of enhancing prevention of tax disputes and controversies. That is sought by granting to large business taxpayers (resident and non-resident) less invasive tax assessments, tax controversies and penalty treatment as well as to offer the Revenue Agency an opportunity to get an insight into the taxpayers' core business in order to focus tax audit/assessment activities towards less collaborative taxpayers.

Therefore, taxpayers admitted to join such regime are compelled to keep a cooperative and transparent relationship with the tax administration, by timely replying to any request from the Revenue Agency and by keeping the latter informed on the tax risks and on any operations that might amount to aggressive tax planning.

Taxpayers who are willing to apply for the program shall first implement an effective tax control framework for detecting, measuring, managing and controlling the risk to breach tax provisions or principles. Moreover, only taxpayers exceeding ten billion euros of total turnover or operating revenues are eligible for cooperative compliance program, unless such value exceed one billion euros and the taxpayer is already included in the pilot program launched in 2013.

Regardless of turnover and proceeds, taxpayers giving execution to advance tax ruling on new investments are also eligible for cooperative compliance program, provided that they set out a tax control framework.

The application is admissible only if it meets certain procedural requirements, namely that it includes the following:

- description of the core business;
- tax strategy;
- description of the tax control framework and of its implementation;
- map of the enterprise processes;

- map of the tax risks and of the associated control systems.

Among the benefits a taxpayer can enjoy after admission to the program, the fast-track ruling procedure is certainly relevant. Moreover, tax penalties are reduced to 50%, and in any case, no penalty may be imposed over the minimum set forth by the law.

From a criminal procedure standpoint, the Revenue Agency may inform the public prosecutor investigating on a suspected criminal offence that a tax control framework is in place.

2. Preventive interaction with the tax administration

The preventive interaction with the tax administration has undergone recent developments (mainly during 2015), aiming to make it the preferred tool for taxpayers. On the one hand, the recast of the advance tax ruling and of the advance pricing agreement provisions brought to the coherent inclusion of such legal instruments among the provisions of major tax laws (respectively, the Taxpayer Bill of Rights and the Presidential Decree no. 600 of 1973 on tax assessment) and partial reshaping of the relevant rules. On the other hand, the catalogue of preventive instruments has widened, now enshrining the brand new advance ruling on new investments.

2.1. Advance tax rulings

The advance tax ruling (ATR) regime has been significantly reformed by Legislative Decree no. 156/2015 (hereinafter the "Decree 156"). The reform of the ATR regime was inspired by the following criteria: (i) coherence in the judicial resolution of tax matters, (ii) timing responses from the tax administration and (iii) simplification of the types of mandatory advance tax rulings when they are burdensome for both taxpayers and the tax administration.

Compared to the previous regime, the new one provides for an actual right of ATR.

2.1.1. The interpretative ruling

The interpretative ruling *(interpello ordinario)* can be requested in case the actual application of a statutory provision is objectively unclear *(interpello ordinario puro)* or the correct qualification of a transaction, for the purposes of applying the relevant statutory provisions, is objectively unclear *(interpello qualificatorio)* (see Article 11(1)(a) Taxpayer's Bill of Rights).

The objective uncertainty is thus a prerequisite for applying for such ruling, implying that the subject matter should be either peculiar (i.e. not recurring) or at least particularly complex.

The interpretation is objectively unclear if the tax authorities have not already expressed their interpretation through a circular letter, ruling or other qualifying administrative document.

By way of examples, taxpayers can apply for an interpretative ruling in order to receive guidance on the potential existence of an enterprise and/or a foreign permanent establishment in case it opts for the tax exemption for the revenues and losses of its foreign permanent establishments (article 168-ter Income Tax Code - hereinafter "ITC"). Moreover, taxpayers can apply for the said ruling in order to receive a certain response on the correct classification of a given type of expense.

The explanatory report accompanying the Decree 156 states that technical evaluations fall outside the scope of interpretative and qualifying rulings, as the tax authorities cannot decide over cases involving mere factual and/or technical evaluations.

2.1.2. The regime admission ruling

Article 11(1)(b) of the Taxpayer's Bill of Rights disciplines the so-called regime admission ruling, which can be requested by taxpayers to obtain the tax authorities' assessment about the taxpayers' fulfillment of the requirements necessary to be eligible for a specific tax regime in expressly provided cases.

The Circular recommends keeping a broad approach in interpreting the meaning of "expressly provided cases", including not only the requests for accessing to the worldwide tax consolidation regime under Article 132 of ITC, but also circumstances in which it is questioned the applicability of certain limitations or special tax regimes (i.e. CFC).

The particular regime admissions rulings expressly provided by statutory provisions are the following:

- requests pursuant to Article 110, para. 11, ITC, according to which *"expenses and other negative items of income deriving from transactions actually performed, which have been duly and materially executed, carried out with resident companies or with entities localized in States or territories with a favorable tax regime, can be deducted up to their arm's lengths value, as determined pursuant to Article 9 [ITC]"*. Provisions from para 10 to 12-bis of Article 110 ITC have been repealed by the Budget Law for 2016 (Law 28 December 2015) starting from fiscal year following that in progress at 31 December 2016. Therefore, the regime admission ruling can be activated only in cases in which taxpayers are still in time to file the tax return;
- requests for the application of CFC regime, with which taxpayers can prove the fulfillment of the conditions provided in para. 5 and 8-ter of Article 167 ITC;
- requests submitted by financial entities pursuant to Article 113 of ITC for the non-application of the participation exemption regime to the participations acquired during debt collection operations deriving from the purchase of shares or the conversion in shares of credit to companies in temporary financial difficulty;
- requests for the continuation of the tax consolidation regime, pursuant to Article 124((5) ITC, submitted during restructuring transactions;
- requests for accessing the worldwide tax consolidation regime, aimed at checking that the conditions for benefiting from the regime are met;
- requests filed by dormant companies and companies which recurrently report tax losses;
- requests for an allowance for corporate equity (so-called ACE).

2.1.3. The anti-abuse ruling

Taxpayers can question the tax authorities whether an actual transaction that the taxpayers are considering to perform may be deemed as abusive based on the general anti-abuse (or anti-avoidance) rule expressed in Article 10-bis of the Taxpayer's Bill of Rights (see Article 11, para. 1, let. c), of the Taxpayer's Bill of Rights). According to the new definition of Article 10-bis of the Taxpayer's Bill of Rights, as amended by Article 1 of the Legislative Decree 5 August 2015 n. 128 (the "Decree 128") an abuse of law exists when one or more transactions *"lack any economic substance and, despite being formally in compliance with tax laws, are essentially aimed at obtaining undue tax advantages"*. These abusive schemes are not enforceable towards the tax authorities, which shall disregard the tax advantages so achieved and compute the taxes on the basis of the rules and principles that have been circumvented, taking into account any tax payments made by the taxpayer in connection with the abusive transactions.

By mean of their application as a general principle, the anti-abusive rulings requests necessarily shall include (i) the detailed indication of the elements that characterize the operation; (ii) the category of tax involved; (iii) the punctual statutory provisions referred to the contested operation; (iv) the sound and non-marginal non-tax reasons, including managerial and organizational ones, aimed at improving the structure or the functionality of the business or the taxpayers' professional activity.

2.1.4. The disapplication ruling

Taxpayers can submit a disapplication ruling pursuant to Article 11(2) of the Taxpayer's Bill of Rights in order to obtain the disapplication of specific anti-avoidance rules, which, for the purpose of tackling abusive practices, limit deductions or tax credits or other benefits,.

This is the only type of mandatory ruling, given the optional nature of the other rulings described above which the taxpayer can submit at its own discretion.

For instance, the disapplication ruling can be submitted against those statutory provisions which limit the carry-forward of tax losses, also in case of restructuring transaction (see Articles 84 and 172 ITC) as well as against dividend washing practices.

2.1.5. General features

With regard to some procedural aspects, applicants to ATR can be either resident or non-resident taxpayers, as well as persons who are in charge of tax compliance obligations on behalf of taxpayers, and withholding agents.

The applicant must submit the tax ruling request before the deadline for the submission of the tax return or for the fulfilment of any other tax obligations connected to the object of the tax ruling request, and annex to it all necessary information and documentation.

The request must contain the following information:

With regard to some procedural aspects, applicants to ATR can be either resident or non-resident taxpayers, as well as persons who are in charge of tax compliance obligations on behalf of taxpayers, and withholding agents.

The applicant must submit the tax ruling request before the deadline for the submission of the tax return or for the fulfilment of any other tax obligations connected to the object of the tax ruling request, and annex to it all necessary information and documentation.

The request must contain the following information:

- identification data of the applicant (and of its representative, if existing);
- indication of type of request, based on the classification above pursuant to Article 11 of the Taxpayer's Bill of Rights, with the express reference to the relevant statutory provisions;
- detailed description of the subject matter;
- the specific statutory provisions for which the applicant asks the interpretation, application or disapplication;
- a clear and unequivocal illustration of the proposed solution;
- indication of the elected domicile and contacts of the applicant;
- the signature of the applicant (or its legal representative) with the power of attorney attached.

The application must be submitted to the regional tax office (Direzione Regionale) of

the region in which the applicant's tax domicile is located. However, the application must be filed with the central department of the Revenue Agency (Divisione Contribuenti) if the applicants are any of the following: (i) central administrations of the State and certain other public entities; (ii) non-resident persons whether or not they have a tax representative in Italy (unless filing the application via their Italian permanent establishment); (iii) taxpayers with a gross turnover of at least 100 million euro.

The filing of the tax ruling application is not subject to any stamp duty.

Under Article 11, paragraph 3 of the Taxpayer's Bill of Right, the tax authorities should issue their response to either the regime–admission ATR (sub paragraph 2.1.2) and the disapplication ATR (sub paragraph 2.1.4) within 120 days (90 days in the case of an interpretative ruling (sub paragraph 2.1.1) from the receipt of the tax ruling application. If the tax authorities deem that the information and documentation submitted by the applicant is not sufficient to provide an answer, they have the right (only once) to request supplementary information and documentation. In this case, the tax authorities have 60 days from the receipt of the additional documentation/information to issue the tax ruling. If the applicant does not receive the tax ruling within the terms indicated above, the solution proposed by the applicant is deemed to be accepted by the tax authorities (silenzio assenso). For these purposes, the deadline is deemed to have been observed if the taxpayer receives the tax ruling within the terms indicated above (i.e. 120, 90 or 60 days, as the case may be).

The interpretation provided in the tax ruling is binding on the tax authorities only vis-à-vis the applicant and only with respect to the specific subject of the ruling. This binding effect generally extends to subsequent transactions or behaviors of the taxpayer that are the same as those represented in the tax ruling application. Tax assessments and similar notices of the tax authorities that are inconsistent with the tax ruling (including the case where the tax authorities have not replied to the applicant within the statutory terms, thereby implicitly accepting the applicant's proposed solution) are void.

With particular regard to the and anti-abuse rulings, the tax authorities answer is binding only with reference to the specific tax provisions addressed in the ATR, thus it is not forbidden to challenge the same operation for the purposes of other taxes.

In case of disapplication rulings, if the outcome of the tax ruling is negative, the taxpayer may still take the position that the specific anti-avoidance rule does not apply to its specific case or transaction and defend such position in case of a later tax audit or litigation.

Tax assessments or tax penalties disregarding the content of the tax ruling are void against the applicant; whereas the ruling published in a resolution or circular letter prevents the tax authorities to apply to any taxpayer inconsistent tax penalties and interests.

With reference to the disapplication and anti-abuse rulings, a peculiar enhanced procedure is provided by the Decree, which is articulated in the following mandatory steps: (i) enhanced claim of the undue deduction/tax credit; (ii) notification, within the ordinary term of tax assessment, of a request for clarification/information in order to enter into discussions with the taxpayer (non-compliance with this requirement makes the final deed of assessment void), (iii) submission by the taxpayer of defensive memoranda within 60 days from the tax authorities' request; (iv) possible extension of the ordinary term of tax assessment; (v) enhanced motivation of the final deed of assessment.

In principle, all types of tax rulings must be in writing and motivated.

2.2. Advance tax agreement (ATA)

Article 1 of Legislative Decree no. 147/2015 (hereinafter "Decree 147") added article 31-ter to the Presidential Decree no. 600/1973 (hereinafter "Decree 600"), which provides for a new advance tax agreement (ATA) procedure that has repealed the previous international tax ruling procedure, once governed by Article 8 of the Law Decree no. 269/2003.

ATA for enterprises with international activities aims at promoting the internationalization of companies and making the Italian tax system more attractive.

With reference to the definition of "enterprises with international business activity", the implementing regulations issued by with act no. 42295 of the Revenue Agency on 21 March 2016 clarify that it addresses Italian resident enterprises, which, alternatively or jointly, meet the following requirements:

a) directly or indirectly, control a non-resident company, are controlled or subject to the same control of a non-resident company, pursuant to Article 110, para. 7, of ITC;
b) their equity, fund or capital is participated by non-resident entities, or they participate to the equity, fund or capital of non-resident entities;
c) they have distributed to non-resident entities or received from non-resident entities, dividends, interests, royalties or other items of income;
d) they carry out their business activity through a foreign permanent establishment.

The objective scope of the new ATA procedure, as provided by the regulations, covers the following areas:

- the determination of the arm's length price of transactions between associated enterprises, and the definition of entry and exit value of assets in case of transfer of residence;
- the attribution of profits and losses to domestic and foreign permanent establishments;
- the prior assessment on the existence of a permanent establishment in the territory of the State;
- the application to a specific set of rules, either national or treaty rules, concerning the payment to (or the receipt from) non-resident companies of dividends, interests, royalties or other items of income;
- the application to a specific set of rules, either national or treaty rules, in order to quantify the amount of taxable income attributable to a permanent establishment in Italy of a non-resident company or to a permanent establishment in foreign companies of an Italian resident company;
- the identification of intellectual property rights that are eligible for a patent box regime issues and the related R&D costs.

Taxpayers may request a pre-filing meeting with the tax authorities (also on a no-name basis) to obtain clarifications on the procedure to be followed.

Within 30 days of receipt of the ruling application, the tax authorities invite the taxpayer to discuss the documentation provided, to request any supplemental documentation and to define the time schedule of the procedure. The entire process must be completed within 180 days from the receipt of the application. The tax authorities will gather information from the documentation provided by the taxpayer, from the meetings and from the ordinary procedures to collect information at the taxpayer's premises, as well as through the exchange of information with foreign tax authorities. In the latter case, the 180-day term is suspended pending the time necessary to obtain the information from the foreign tax authorities. The procedure concludes with the signing of the ATA.

In principle, the ATA is valid for 5 fiscal years, i.e. for the fiscal year in which it is signed and for the following 4 fiscal years, provided that the underlying factual and legal circumstances remain unchanged.

Unlike the old international ruling, Article 31-ter of the Decree 600 expressly regulates the rollback effects of the ATA. In particular (i) in the case of ATA based on arrangements reached with the competent authorities of other countries under the mutual agreement procedure provided by the tax treaties, the ATA is also binding for previous fiscal years (but not for fiscal years before the fiscal year in which the application was filed); and (ii) in all other cases, taxpayers may decide to roll back the terms of the ATA to previous fiscal years (but not to fiscal years before the fiscal year in which the application was filed), provided that there have been no changes in the underlying factual and legal circumstances that occurred (e.g. the taxpayer may align its transfer prices to reflect the terms of the unilateral APA). The taxpayer has to file an amended tax return for the previous years or voluntarily pay any deficiency resulting from applying the terms of the ATA to such previous years. The taxpayer is not subject to penalties.

After the execution of the ATA, the taxpayer must periodically (or upon specific request) submit documents and information to allow the tax authorities to monitor the compliance with the terms of the ATA. The tax authorities may also have access to the taxpayer's premises.

Should tax authorities determine that the underlying factual or legal circumstances of the ATA have changed, they send a notice to the taxpayer to discuss the potential amendments to the ATA.

However, if the parties do not agree on how to amend the ATA, or should the changes in the underlying factual or legal circumstances of the ATA prevent any amendment, the ATA is terminated and ceases to be effective and binding as of: (i) the date when the factual (or legal) change has occurred; or if this cannot be determined (ii) the date on which the tax authorities served the notice on the taxpayer.

Until the ATA is valid and binding, the tax authorities can exercise their audit or assessment powers only in relation to matters other than those agreed upon in the ATA. If the taxpayer violates the ATA, the tax authorities serve a notice on the taxpayer inviting the taxpayer to submit a defensive brief within 30 days. Failure to timely submit such brief, or in the absence of an agreement with the taxpayers' defensive arguments, the ATA is deemed to be terminated as of: (i) the date when the violation has been detected; or if this cannot be done (ii) the signing date of the ATA.

ATAs may be renewed and, to this end, taxpayers must send a renewal notice to the tax authorities no later than 90 days before the expiry of the ATA.

2.3. Advance ruling on new investments

The advance ruling on new investments, also introduced by the Decree 147, is addressed at investors (both resident and non-resident), who intend to make a significant and long-term investment in Italy, in order to receive guidance on any tax aspect of the investment, including anti-abuse provisions, tax benefits and the existence of a permanent establishment of a non-resident enterprise.

The Revenue Agency Circular letter no. 25 of 1 June 2016 provides instructions on the specific ruling procedure.

In order to be considered as relevant for the purposes of the ruling, the applicant taxpayer shall prove that the value of the investment plan, including the corporate operations scheduled

for the relevant implementation, exceed 30 million euros.

However, the ruling cannot concern the subjects falling within the scope of the APAs.

On the other hand, if the taxpayer seeks for a ruling concerning local taxation, the Revenue Agency is supposed to forward the application to the competent local administration, which will directly reply on taxpayer's requests.

Applicants to new investments rulings can be either persons who invest in the course of their business (such as individual entrepreneurs, corporations, trusts, partnerships, etc.) and persons who act outside a business activity (banking foundations, collective investments schemes, etc.), as well as company groups or groupings of enterprises.

The investment may be apportioned among several tax periods.

For being eligible for the advance tax ruling at hand, the investment can be any (included a combination of two or more) of the following;

a) creation of new economic activities (e.g. establishment of a new company, also through participation in public tenders) or expansion of existing ones, with consequent reorganization of productive, commercial or administrative structure;
b) diversification of production of an existing production unit, with respect to the size of the activity currently carried out, or the types of goods or services provided, and/or the target markets;
c) restructuring of an existing business activity in order to enable the company to overcome or prevent a crisis situation, through the specific instruments provided by law (e.g. agreements with creditors, debt restructuring agreements, etc.);
d) operations involving participation in the equity of the enterprise.

Among the requirements set forth by the law, the investment must be significant and have a long-lasting impact on employment, in terms of creation of new jobs or maintenance of existing employment levels. The impact of the investment plan for enterprises in crisis, instead, shall be valuable as to avoid layoffs, mobility lists and redeployment schemes.

Those elements shall be assessed in relation to the activities addressed by the investment plan through a case-by-case analysis of the specific business carried out by the investors.

The application is admissible also upon the following conditions:

- submission before the statutory deadlines for tax return filing or any other tax fulfilment related to the investment plan (e.g. registration of documents);
- uncertainty on the applicable law occurs (and the issues comprised by the application have not been analyzed yet);
- non-assessment or administration's self-protection procedure have commenced yet (such inadmissibility impinge also the applications filed in the interest of multiple taxpayers), and the target company has no formal awareness of any tax monitoring activities towards itself.

The ruling binds the Tax Administration, which cannot amend it via self-protection procedure, and any administrative act in breach of the ruling would then be void, unless out of the ruling scope. The Revenue Agency may verify the taxpayer's conduct with respect to the issues subject to the ruling and if the circumstances of law and of fact have changed.

The ruling shall be issued within 120 days and, if the tax authorities do not reply in due time, the tax treatment outlined by the taxpayer in the application is deemed to be accepted. In case of further information needed, the deadline can be extended by 90 more days starting from the day in which the required information is received.

Moreover, regardless of the amount of turnover or proceeds, the taxpayer who complies with the ruling has access to the cooperative compliance program, on the sole condition that a tax control framework is set out in the investing company and in the company whose equity is targeted by the investor.

3. Audit and assessment

Audits and assessment are a typical administrative activity of tax law enforcement.

The relevant law provisions establish different kinds of audits:

- automatized audit on tax returns;
- formal check on tax returns;
- correspondence audit;
- field audit (inspection).

Automatized audits (Article 36-bis of the Decree 600) occur within the beginning of the period during which tax returns for the following fiscal year are filed by taxpayers and aim at matching the tax returns with the data stored in the tax register. In case the automatized audit reveals an omitted payment or a tax deficiency, the taxpayer may provide the tax administration with all the relevant clarifications within thirty days following the receipt of the relevant notice.

Formal checks under Article 36-ter of Decree 600, instead, are carried out by Revenue Agency officers by the end of the second calendar year following the filing of the tax returns. In such a case, the taxpayer or the withholding agent is invited, even by phone, to provide further information or certain documents required by the tax administration.

Turning to correspondence audits, those are not specifically prescribed by the law, but practically carried out from the Revenue Agency's offices. Differently from automatized and formal checks, those are closer to a tax investigation and may entail the issuance of questionnaires addressed to the taxpayer or to others in order to retrieve useful information. In certain cases (i.e., mainly, when the Revenue Agency deem such way of investigating useful), the tax administration carries out bank inquiries on the taxpayer's accounts; also third-party accounts may be addressed by the bank inquiry (e.g., audit practice even conceives bank inquiries on accounts held by relatives of companies' board members).

Finally, field audits are the most complete form of tax investigation. Those are physically carried out at the premises or in any place at the disposal of the taxpayer, and sometimes those are carried out at the premises of other taxpayers (e.g.: clients of the audited taxpayer, aiming at verifying the existence of agents of the latter amounting to a personal permanent establishment). During field audits, the auditors (Revenue Agency or Tax Police; only the latter if a criminal investigation is already commenced) always record their activities on daily audit reports, and they deliver a final tax audit report to the taxpayer at the end of the audit. Audit practice conceives also interim tax audit reports, seldom used to give rise to exchange of positions between auditors and taxpayer; in most cases, interim reports are just a draft of the final audit report and are relevant from a purely defensive standpoint in order to elaborate the following steps and strategies.

Auditors may also interview any person at the premises of the taxpayer, especially employees, so as to verify also compliance with labor law (Tax Police may act also as labor inspector).

The field audit commences with a preliminary written discovery on the scope of the audit, i.e. the auditors display the inspection authorization released by the person in charge of

the auditing office. In case field audit extends to other places (private houses or mixed-use places) and to personal inspections or forced opening of sealed correspondence and safes, the inspectors shall be also authorized at least by the Public Prosecutor office.

Any document whose disclosure is denied by the taxpayer cannot be then assume proof value in court: such rule concerns mandatory documentation (e.g. company's records) and with documents specifically requested during the audit. Auditors may even seize documents which cannot be copied and analyze data stored on electronic devices outside of the audited premises (the latter occurs if the taxpayer prevents the auditors from retrieving electronically stored data by availing themselves of premises' devices and personnel).

After a field audit's conclusion (i.e. delivery of the final tax audit report), the law proscribe the issuance of tax assessments by the Revenue Agency during the following sixty days, during which the taxpayer is entitled to submit defensive memoranda or may be invited to appear before tax administration. In other words and in any case, the taxpayer is entrusted with the right to be heard in advance. Such principle is enshrined by the settled case law of the Supreme Court and, with reference to custom duties, VAT and excise duties, by the European Court of Justice.

At the moment, a much debated theme regards the relevance of taxpayer's right to be heard in advance also during correspondence audits which, according to the most recent judgments of the Supreme Court, do not entail any audit report and, therefore, there is no starting date for the sixty-day term to exercise the aforesaid right. Scholars have deeply and unanimously criticized such approach, being deemed discriminatory among field audits (allowing the taxpayer to be heard before the assessment) and correspondence audits (which are interpreted as excluding any preliminary exchange of positions and views with the taxpayer).

Once the deed of assessment is issued, it becomes enforceable after the deadline to appeal expires on the condition that it is concerned with State taxes; in such a case, the collecting agent may register State's credit with no preliminary payment notice. Payment notice, instead, is still prescribed for collecting local taxes and for collecting tax deficiencies discovered during automatized and formal checks: in the latter cases, no assessment is issued.

The deeds of assessment shall include all the reasons supporting the tax deficiency, and usually contain the imposition of tax penalties, accordingly with the assessed violation.

4. Court litigation

Any deed of tax assessment may be challenged before tax courts, whereas the law envisages no administrative appeal. More specifically, the law stipulates that the taxpayer may avail himself of the tax settlement procedure, which ends nonetheless with a tax assessment, even though its contents are "agreed" between the parties (a sort of tax plea bargain).

Besides, the taxpayer may promote the start of an administrative self-protection procedure, of which the tax administration may even freely avail itself, however with no obligation nor deadline to decide on the taxpayer's application.

In light of the above, if the contested liability for tax deficiency is completely ill founded, the judicial appeal is the sole legal remedy capable of effectively counteracting the whole assessment. Obviously, a tax lawsuit may concern also partially ill founded assessments.

With respect to refund requests filed with tax administration, the lack of a decision after ninety days implies the denial of the refund. Even if the denial is explicit, no tax settlement procedure is available, and the self-protection procedure features the aforementioned absence

of time limits and of any obligation even to consider taxpayer's position.

The tax courts, in general, are competent for the appeals concerned with taxes, limited to the appealable deeds listed by article 19 of the legislative decree no. 546 of 1992. The settled case law of the Supreme Court states that such provision should not to be strictly interpreted; therefore, any deed imposing a tax and pointing out the factual and legal reasons entailing the exercise of the power to tax shall be deemed appealable before tax courts. For instance, the current case law deems automatized and formal checks on tax returns appealable, whereas final tax audit reports are still deemed not challengeable before tax courts.

From evidentiary standpoint, the civil procedure rule of onus probandi (burden of proof) is fully applicable in tax litigation; therefore, who claims a right must prove it, and who urges against the existence of a right must accordingly come forward with proper evidence (article 2697 of the civil code). Consequently, the taxpayer shall prove his right to refund or, in response to the tax assessment, the inexistence of the assessed tax deficiency. Moreover, article 7.4 of the legislative decree no. 546 of 1992 stipulates that no oral evidence (e.g. witness) is admitted in tax trials.

The first-tier appeal is to be brought before the Provincial Tax Court in whose territory the assessing office is located. For instance, if the Revenue Regional Directorate of Milan issues the deed of assessment, the case will be pled in the Provincial Tax Court of Milan.

The procedure to file an appeal follows a notification-lodging sequence. First of all, the taxpayer notifies the appeal to the defendant (i.e., the assessing office or/and the collecting agent) within sixty days following the receipt of the deed of assessment or of the appealable deed. Such rule is excepted in case of silent denial of a refund request: the appeal may be notified to the defendant only after ninety days following the submission of the refund request and within the deadline set forth by the statute of limitations (ten years). Afterwards, the appellant is supposed to lodge the notified appeal with the Registry of the Tax Court within thirty days following the notification.

The appeal does not automatically suspend the collection of the tax deficiency. In fact, in order to suspend such collection, a specific injunction against the collection shall be requested by the appellant and granted by the Court. In any case, the collecting agent is entitled to temporarily register in its books one third of the assessed tax.

The defendant may lodge with the Court a pleading in objection within sixty days following the receipt of the appeal notified by the appellant.

The proceeding is usually made up of just one hearing, which is not public unless that is specifically requested by one of the parties. The parties may still come forward with documents and lodge them with the Court until the twenty-second day before the hearing; they may also file further defensive pledging until the twelfth day before the hearing.

The party having interest in a more favorable judgment (both parties if the appeal is partially admitted) may appeal the first-tier judgment before the Regional Tax Court within sixty days following the notification of the judgment made by the awarded counterparty or within six months following the publication of the same judgment.

During the second-tier stage of the proceeding, new documents and new pleas are barred, unless the party interested in those proves not to have been able to timely come forward with evidence.

The judgment of the Regional Tax Court may be appealed before the Supreme Court in Rome (Corte di Cassazione, literally "quashing court") within the same deadlines for the notification to the defendant as above. Afterwards, the appeal shall be lodged within twenty days following the latest notification.

Such remedy is strictly limited with respect to the types of admissible pleas, which can focus solely on the law and on the second-tier judgment (article 360(1-5) of the civil procedure code): judicial competence issues, breach of law, void judgment or proceeding and omitted analysis on a decisive fact discussed by the parties. No plea is admitted on inadequate statements of the judgment, unless the law infringement impinges the minimum obligation to state reasons for judgment's holding, set forth by article 111 of the Italian Constitution. According to the settled Supreme Court case law, a plea on the statements shall be grounded textually on the second-tier judgment and is admissible on the condition that the judgment has no statements justifying the holding at all, or such statements are merely apparent, irremediably contradictory or manifestly illogic.

The appellee may file a counter-appeal within twenty days following the deadline for main appeal lodging.

If the appeal looks clearly inadmissible (e.g. plea not reconcilable with the listed ones, or lack of essential elements of the appeal, or compliance of the appealed judgment with settled case law of the Supreme Court and no distinctive elements leading to an overruling) or manifestly unfounded, the Sixth Chamber "filters" the appeal by dismissing it. If that does not occur, then the Fifth (Tax-specialized) Chamber hears the case (publicly only if there is conflicting case law in lower courts) and decides the appeal.

The Supreme Court either dismisses the appeal or quashes the appealed judgment. In the latter case, the Supreme Court may give judgment on the substance (if no further factual assessment is required) or refer the case back to a different chamber of the Regional Tax Court, if further factual assessment is required. In such a case, the referred Tax Court is supposed to stick to the law principle held by the Supreme Court.

The judgment of referred Tax Court may be appealed solely for its own breaches of law, including the infringement of the law principle stated by the quashing judgment of the Supreme Court.

A major feature of Italian legal system is the lack of a stare decisis rule; therefore, any law principle stated by the Supreme Court cannot legally bind lower courts in other proceedings. However, the single chambers of the Supreme Court are bound by United Chambers judgments, and if a single chamber does not agree in principle to any relevant holding of the United Chambers, the latter shall decide the appeal at the bar (article 374.3 of the civil procedure code).

In the Italian legal system, the judgment becomes res iudicata (definitively deciding and closing the case at the bar) if no appeal could be brought before a court (e.g. the Supreme Court dismisses the appeal or quashes the second-tier judgment without referring back to lower courts, or appeal against a lower court judgment is time-barred).

The judgments are immediately enforceable if favorable to the taxpayer. If not, the contested tax may be gradually collected: not exceeding two thirds after first-tier dismissal judgment, the remaining amount accordingly with the second-tier judgment, and not exceeding one third if the Supreme Court quashes the second-tier judgment referring the case back to a different chamber of the Regional Tax Court.

Any issue pertaining to the enforcement of the judgment is to be lodged via a specific appeal addressed to the Chief Judge of the Tax Court whose judgment is res iudicata, and if the Supreme Court issued the judgment at stake, the Regional Tax Court would be competent for the enforcement proceeding.

5. Mutual Agreement Procedures (MAPs)

Mutual agreement procedures ("MAP") serves as an instrument, in alternative to domestic tax litigation procedures, of direct consultation between the tax admirations of two (or more States) to settle international tax controversies connected with double taxation.

Taxpayers can opt for two alternative proceedings, i.e. MAP pursuant either to the relevant double tax convention, if any, or MAP under the Convention 90/436/EEC of 23 July 1990 on the elimination of double taxation in connection with the adjustment of profits of associated enterprises (hereinafter referred to as "Arbitration Convention"). Italy has entered into DTAs with over 90 countries throughout the world, most of which are based on the OECD Model Tax Convention and contain a provision equivalent to Article 25 of the OECD Model Tax Convention.

In case of DTC MAP, competent authorities are not committed to find a mutual agreement to eliminate taxation not in accordance with the DTC solve the case (so called "obligation of result"), being requested only to endeavor to solve the case. On the contrary, the Arbitration Convention provides for a MAP in matters concerning the allocation of profits between affiliated companies as well as in relation to foreign permanent establishments. The EU Arbitration Convention prescribes that the States involved have to come to an agreement in any case. If the States are not able to reach an agreement on the elimination of double taxation within two years from the date on which the case was first submitted, a special arbitration procedure is prescribed to eliminate the double taxation through the setting up of an advisory commission in charge to deliver an opinion on the elimination of double taxation in question.

Part 2

Italian permanent establishments of foreign banks

Chapter 1

Permanent establishment under Italian law and treaties

Alessandro Caridi | Marianna Franchini | Matteo Calizzi

1. Introduction

Italian official interpretations of the notion of permanent establishment ("PE") are not in line with most countries ever since the Phillip Morris cases on agency PE and a *sui generis* "multiple PE" concept. Even more so, the 2018 Budget Law amended the definition of PE in the Italian Tax Code ("ITC"), introduced in 2004 based on criteria derived from the Italian tax treaty network which mainly followed the 1963 OECD Model, in order to address Base Erosion and Profit Shifting ("BEPS") related issues (e.g. extension of the positive list, limitation of the negative list, anti-fragmentation rule).

However, any PE analysis must necessarily take into consideration the specific double tax convention ("DTC") between Italy and the residence state of the enterprise, if any. Moreover, a complete analysis will have to address the impact of the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS* ("MLI") on the specific DTC, if applicable. In fact, according to art. 169 of the ITC, the domestic rule can override an applicable treaty only in case it grants a treatment that is more beneficial for the taxpayer.

On top of that, the Italian Tax Authority ("ITA") has an "aggressive" approach, and tends to be BEPS compliant even in the lack of solid positive law basis, inclined to follow the "substance over form" mantra.

2. Definition of Permanent Establishment according to the current version of the OECD Model

Article 5 of the OECD Model provides for a definition of the PE concept, which is a tax notion aimed at defining a threshold above which a State may tax business profits earned therein by a resident of another (contracting) State.

The notion of PE is one of the issue involved in the OECD BEPS Project. On October 5, 2015, the Final Report of Action 7 of BEPS Project "Preventing the Artificial Avoidance of Permanent Establishment Status" has been published, containing the changes to Article 5(4), (5) and (6) of OECD Model and Commentary. On December 2017, the OECD Model condensed version has been released, reflecting, inter alia, OECD BEPS Project proposed changes to Article 5.

The two major point of focus of the OECD work on PE notion have been:

- the notion of "conclusion of contracts" for the purposes of determining whether an Agency PE exists;

- the activities having preparatory or auxiliary nature and the introduction of an *Anti-fragmentation rule*.

Article 5(1) contains the so-called **Physical PE definition**, according to which the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

The term "place of business" covers any premises, facilities, etc. used for carrying on the business of the enterprise, whether or not they are used exclusively for that purpose. A PE may be deemed to exist if it is found that the principal company has at its disposal, and regularly uses, a fixed place of business in the Italian territory through which the business is carried on. It is immaterial whether the foreign company has legal title over the premises or not, as a PE may be envisaged also if the enterprise has at its disposal the business facilities of another enterprise. In other words, the disposition right does not necessarily have to be based on a contractual relationship, but it can be envisaged on factual basis, while mere presence at a place should not imply the disposal of it. As such, the definition of "place of business" can be widely interpreted.

Article 5(2) contains the so-called **positive list**, to be considered as potential "places of business": branch, office, factory, etc. Article 5(2) provides that these (places of business) are "especially" included in the definition of a PE. The article has universally been interpreted to mean that such places of business should be considered as prima facie PEs, meaning that they should constitute a PE only to the extent they meet the requirements of Article 5(1). On this point, from 1977 until 22 July 2010, an observation to the OECD Commentary clarified that Italy does not adhere to the interpretation concerning the list of examples of paragraph 2: in its opinion, these examples can always be regarded as constituting a priori permanent establishments

Article 5(3) deals with the so-called **construction PE**, which generally exists to the extent a building site, construction or installation project lasts for more than 12 months. Such provision is generally interpreted so as to include under the construction PE clause on-site planning and supervision activities, whether done by a subcontractor or by a third party.

Article 5(4) contains the so-called **negative list**, i.e. a list of activities that do not, by themselves, constitute a PE even if conducted through a fixed place of business. The essential feature of these activities is their preparatory or auxiliary character. Article 5(4) has been modified further to Action 7 so to narrow the application of the exceptions listed therein only if the business activities under analysis have preparatory or auxiliary nature, so that the notion of PE does not include:

a) the use of an installation solely for the purpose of the storage, display or delivery of goods belonging to the enterprise;
(b) the maintenance of a stock of goods belonging to the enterprise solely for the purpose of storage, display or delivery;
(c) the maintenance of a stock of goods belonging to the enterprise solely for the purpose of processing by another enterprise;
(d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or collecting information for the enterprise;
(e) the maintenance of a fixed place of business solely for the purpose of carrying on, by the enterprise, of any other activity;
(f) the maintenance of a fixed place of business solely for any combination of the activities referred to in (a) to (e).

provided that such activity or, in case of subparagraph (f), the overall activity of the fixed place of business is of a preparatory or auxiliary character.

Specifically, under such new wording, subparagraph (e) gains a "catch all nature", including any other activity not otherwise listed under the previous letters.

Provided that a case-by-case analysis is always necessary to determine whether one of the exceptions under Article 5(4) is applicable or not, the Commentary states, by way of example, that:

- an activity may reasonably be considered as preparatory to the extent (i) it is followed by another activity having essential nature and (ii) it is carried on for a short period of time;
- an activity could not be considered as having auxiliary character if it is highly labour consuming.

Moreover, a specific anti-fragmentation rule has been introduced under paragraph 4.1 of Article 5, so to prevent an enterprise or a group of closely related enterprises from splitting up a cohesive business into several small operations between different places of business in the same State so to argue that the activity carried on in each one is merely preparatory or auxiliary.

Broadly speaking, in order to ascertain whether the activities carried on by an enterprise through a fixed place of business in a contracting State are of preparatory or auxiliary nature or not, also other complementary functions carried on by the same enterprise or by other closely related enterprises through other fixed places of business in the same contracting State must be considered.

Articles 5(5) and 5(6) rule the so-called **Agency PE**. Generally, if no PE is found under Articles 5(1) nor 5(3), there may be an Agency PE under the rules of paragraphs 5 and 6. The first aim of Action 7 was to include in the notion of Agency PE also commissionaire arrangements, a widespread contractual scheme among MNEs, through which a person sells products in a State in its own name but on behalf of the non-resident enterprise that is the owner of such products.

According to the new Article 5(5), an Agency PE may be envisaged, irrespective of the conclusion of contracts in the name of the enterprise, when a person acting in a contracting Sate on behalf of an enterprise:

a) habitually concludes contracts; or

b) habitually *"plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise"*

and the contracts so concluded are:

c) in the name of the enterprise; or

d) for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that such enterprise has the right to use; or

e) for the provision of services by that enterprise.

In any case, no PE should be deemed to exist in case the activities performed by such person are covered under the independent agent exception contained in paragraph 6 or to the extent the activities, although carried on through a fixed place of business, are of an auxiliary or preparatory nature.

According to the rephrased provision, an enterprise is now deemed to have a sufficient taxable nexus with a State also in case the contracts, concluded in its own name or otherwise binding such enterprise, is the direct result of the actions of a person, if such person is not acting as an independent agent. A person is acting on behalf of an enterprise in a contracting

State to the extent the latter is directly or indirectly affected by the actions of such person in the contracting State.

According to the updated Commentary the "conclusion of contracts" should be evaluated in the light of the applicable contract law (e.g. under the relevant law a contract may be concluded by acceptance, no matter the State where it signed), while the qualification of the role played by the person as "principal" should be associated with the actions of the person who convinced the third party to conclude the contract.

In any case, the Commentary specifies that a substantial analysis of the commercial relations of the specific case is needed in order to ascertain whether the role played by the person is "principal" or not, being not sufficient the mere participation to the negotiation phase. Please note that Italy has made a reservation on this part of the commentary, clarifying that domestic jurisprudence – not explicitly referring to the Phillip Morris cases – is not to be ignored (even if Italy is a civil law system), and the reservation made in 2005 is still found in the latest post-BEPS version of the Commentary.

A substantial analysis is needed also with reference to the independent status, provided that some guidance and criterion to be used are given under the Commentary. For example in case:

a) the actions of the agent are subject to detailed instruction or to comprehensive control by the enterprise;
b) the entrepreneurial risk is borne by the enterprise;
c) the agent acts exclusively or almost exclusively for one or more closely related enterprises;
d) the agent's remuneration is based on the enterprise's turnover;
e) the agent provides substantial information to a principal of the enterprise to seek approval on how to conduct the business under the agreement to be operated such independent status may be hardly envisaged.

Under Article 5(7) a company resident in one State should not be automatically considered a PE of a company resident in the other State simply because the latter controls or is controlled by the former. However, when the premises of one company are de facto at the disposal of the other company and the conditions for the application of Article 5(1) are met, a Physical PE will exist. Also, if one company can be considered a dependent agent of the other company under Article 5(5), an Agency PE may be found.

Article 5(8) introduced in the new condensed version of the OECD Model contains the notion of "closely related" person or enterprise for the purposes of the application of the anti-fragmentation rule and of the Agency PE rule. As a general rule, a person or enterprise is deemed to be closely related to an enterprise if, based on all relevant facts and circumstances, one has control over the other or both are controlled by the same persons or enterprises. A person or enterprise is automatically deemed to be closely related to an enterprise if (i) it owns, directly or indirectly, more than 50 per cent of the beneficial interests in such enterprises or (ii) a third person owns, directly or indirectly, more than 50 per cent of the beneficial interests in both the person and the enterprise or both enterprises. In case of a company, such requirement is deemed to be met in case a person holds, directly or indirectly, more than 50 per cent of the voting rights and the value of the company's shares or of the beneficial equity interest in such company.

3. Multilateral Instrument for Modifying Bilateral Tax Treaties – the position of Italy

Under Action 15 (Developing a Multilateral Instrument for Modifying Bilateral Tax Treaties) of the BEPS Project, a multilateral instrument ("MLI") to modify existing bilateral treaties - so as to allow consistent implementation also of the proposed changes to Article 5 of OECD Model as per Action 7 in the scope of treaties already in place - has been released in November 2016. In broad terms, an ideally complete application of the MLI provisions to an existing convention would have effects similar to those resulting from the last OECD Model.

Articles from 12 to 15 of the MLI allow countries to amend their tax treaties to implement the tax treaty-related BEPS recommendations contained in Action 7:

- Article 12 deals with artificial avoidance of PE status through commissionaire arrangements and similar strategies;
- Article 13 deals with artificial avoidance of PE status through the specific activity exemptions and fragmentation of activities;
- Article 14 deals with the splitting-up of contracts issue, in relation to building site PE; and
- Article 15 contains the provisions related to the definition of a person closely related to an enterprise, thus being complementary to provisions under Article 12 and 13.

Banking sector should be impacted by amendments made to tax treaties pursuant to Article 12 and 13.

In amending their treaty network, OECD Member States may reserve the right not to apply Article 12 and 13 in their entirety or in part. Such right to make reservations to opt out these articles is based on the fact that provisions addressing artificial avoidance of PE status through commissionaire arrangements and similar strategies or through the negative list and fragmentation of activities between closely related parties are not required in order to comply with a minimum standard. In case of reservations on Article 12 and 13, Article 15 (dealing with the definition of a person closely related to an enterprise) may not apply in its entirety or in part, accordingly to the reservations made.

The amendments to tax treaties shall become effective once all parties to that treaty have ratified the Multilateral Convention and:

- with respect to withholding taxes and to amounts paid or credited to non-residents, where the taxable event giving rise to the tax obligation occurs after the first day of the next calendar year that begins on or after the latest of the dates on which the Multilateral Convention enters into force for each of the Contracting States;
- with respect to all other taxes, from the latest of the dates on which the Multilateral Convention enters into force for each of the Contracting States.

The MLI is already in force for some of the signatories which have deposited their instrument of ratification, acceptance or approval of the treaty.

Italy signed the MLI, together with other 66 jurisdictions (the number of signatories as of 27 September 2018 is 84), during the signing ceremony held in Paris on 7 June 2017, but the Italian procedure of ratification has not yet been completed. The agreements Italy wishes to be covered by the convention are 84, out of 104 constituting its double tax treaty network, and the changes would be effective only if and when the other contracting state of the specific treaty takes such a position, and the MLI enters into force in both jurisdictions.

With reference to the rules concerning PEs, Italy chose to apply Option A under article 13(1) but reserved the right not to apply to its Covered Tax Agreements provisions dealing with

commissionaire arrangements and the splitting-up of contracts included in articles 12 and 14. As a result, article 15 on the definition of a person closely related to an enterprise shall be effective only with reference to the anti-fragmentation rule contained in article 13(4). Should these reservations be confirmed by Italy upon ratification of MLI, the revised Agency PE and splitting-up of construction contracts provisions shall not be applicable to double tax treaties entered into by Italy.

4. Definition of Permanent Establishment according to Italian law

The domestic notion of PE has been modified by Finance Act for 2018 including measures implementing the recommendations contained in the Final Report of BEPS Action 7.

4.1. Physical PE

The notion of PE provided by Italian domestic tax law is more inclusive than the PE notion provided for under article 5 of the Model income double tax treaty.

According to Article 162 of ITC, the term "permanent establishment" identifies a fixed place of business through which the business of the non-resident enterprise is wholly or partly carried on in Italy.

In a nutshell, a PE is envisaged in the existence of (i) a place of business, (ii) which is permanent from a geographical as well as a temporal perspective, (iii) which is at the disposal of the enterprise, (iv) and through which its business is carried on.

This general definition does not substantially differ from Article 5(1) of the OECD Model Convention.

The second paragraph of Article 162 provides a non-exhaustive list of examples that may constitute a PE whenever the requirements set forth under the first paragraph are met (s.c. "positive list"):

a) a place of management;
b) a branch;
c) an office;
d) a factory;
e) a workshop, and
f) a mine or an oil or gas well, a quarry or other place for the extraction of natural resources, even if located in areas outside the territorial waters in which, in accordance with customary international law and the relevant domestic legislation on the exploration and the exploitation of natural resources, Italy can exercise its rights on the seabed, the subsoil and its natural resources; (f-bis) a significant and continuous economic presence in the territory of the State set up in such a way that it does not result in a physical presence therein.

The newly introduced letter (f-bis) provides for a new taxable nexus concept - alongside with the traditional one based on the physical presence in a territory - aimed at broadening the PE notion as to include also those business models entailing the maintenance of a relationship with clients mainly through remote devices or other digital means.

The wording of the provision is quite generic and, to date, there are no guidelines on the concept of "economic presence" nor on how to identify the threshold of significance. However, considering that the wording of the provisions seems to recall the recommendations included in the Final Report of Action 1 of BEPS Project "Addressing the Tax Challenges of the Digital

Economy", we would anticipate that the Italian tax authorities could make reference to BEPS work on digital economy when assessing whether an activity carried on by a non resident may fall under the scope of letter (f-bis).

Until 2018, Italian law expressly provided for the possibility of electronic equipment to give rise to a PE.

According to the version of Article 162(5) of ITC in force until 2017, the disposal of electronic processors and auxiliary equipment enabling the collection and transfer of data and information for the purpose of selling goods and services did not, in itself, constitute a PE. In any case, an analysis of the relevant facts and circumstances was needed to evaluate whether the electronic equipment in Italy was used for functions that can be considered as preparatory or auxiliary.

This provision - not contained in the OECD Model itself - reflecting the content of the Commentary dealing with server PEs has now been repealed effective from 2018. As a consequence, one may argue that the collection and transfer of data and information for the purpose of selling goods and services through electronic equipment may now be deemed to give rise to a PE if the requirements of significant and continuous economic presence provided for under letter (f-bis) are met.

4.1.1. Building site PE

Under Article 162(3) the notion of PE is extended to a building site, construction, assembly or installation project or supervisory activities connected therewith, to the extent that such site, project or activities last for more than 3 months. The main differences between the Italian notion of building site PE and the one provided under the OECD Model lie in the 3-month period and in the explicit reference to the "supervisory activities". In the lack of an explicit reference to planning activities, it could be reasonably argued that such activities are excluded from the notion of building site PE.

This provision should be of no relevance for foreign banks carrying on business in Italy through a PE.

4.1.2. Preparatory or auxiliary activities

The fourth paragraph contains the so-called "negative list", namely a list of the business activities that, although carried on through a fixed place of business, do not give rise to a PE in Italy.

The list of exceptions includes:

a) the use of an installation solely for the purpose of the storage, display or delivery of goods belonging to the enterprise;
b) the maintenance of a stock of goods belonging to the enterprise solely for the purpose of storage, display or delivery;
c) the maintenance of a stock of goods belonging to the enterprise solely for the purpose of processing by another enterprise;
d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or collecting information for the enterprise;
e) the maintenance of a fixed place of business solely for the purpose of carrying on, by the enterprise, any other activity; and
f) the maintenance of a fixed place of business solely for any combination of the activities referred to in (a) to (e).

Before the 2018 amendments, the list included activities that were considered to have a preparatory or auxiliary nature in themselves, thus being possible to interpret its effect as an automatic exclusion of the existence of a PE in case such activities took place. However, considering that under current business models such activities, in certain circumstances, could correspond to core business functions, according to BEPS Action 7 recommendations, the domestic provision now expressly specifies that the application of the exception is restricted only to activities that are of preparatory or auxiliary nature. By reflecting article 5(4) of the 2017 OECD Model and option A of article 13(1) of MLI, the newly introduced paragraph 4-bis states the above listed activities – therefore to be considered as mere examples - should not give rise to a PE provided that the overall activity carried out at such fixed business place is of preparatory or auxiliary nature.

4.1.3 Anti-fragmentation rule

Article 162(5) contains an anti-fragmentation rule aligned with the one provided for in BEPS Action 7, so that whether an activity may be considered to have preparatory or auxiliary nature, thus not triggering any PE existence, should be evaluated in the light of the overall activity carried on by other closely related persons or enterprises in the Italian territory. The same ideal is reflected in the Italian choice not to opt-out of the corresponding paragraph of the MLI.

4.2. Agency PE

Paragraphs (6) and (7) have also been amended as to include BEPS Action 7 recommendations on commissionaire arrangements strategies, notwithstanding Italy, when signing the MLI, reserved the right to not apply such provisions – maybe because in the light of its jurisprudence (see below) this might have been considered unnecessary.

A resident or non-resident person:

a) acting in the Italian territory on behalf of a non-resident enterprise, that habitually concludes contracts in Italy in the name of a non-resident enterprise,
b) or plays a role in the conclusions of contracts that are habitually concluded and without substantial modifications from such non-resident enterprise

and these contracts are:

c) in the name of the enterprise; or
d) for the transfer of the ownership of, or for the granting of the right to use, property owned by that non-resident enterprise or that such non-resident enterprise has the right to use; or
e) for the provision of services by such non-resident enterprise constitutes a PE in Italy of the non-resident enterprise, unless his activities are of an auxiliary or preparatory nature.

No PE is deemed to exist also if such person qualifies as an independent agent carrying No PE is deemed to exist also if such person qualifies as an independent agent carrying out the activities for the benefit of the non-resident enterprises in the context of his own ordinary business. The independence requirement is not considered to be met if a person acts exclusively or almost exclusively on behalf of one or more closely related enterprises. (Article 162(7)).

Such a definition is line with Agency PE notion provided for in the updated OECD Model.

4.2.1. Closely related person or enterprise

Article 162(7-bis) provides a notion of "closely related person or enterprise" - aligned with Article 5(8) of the 2017 OECD Model - for the purposes of the application of the anti-fragmentation rule and of the Agency PE rule.

4.2.2. Maritime trade agent

Under Article 162(8) of the ITC, the mere fact that a company carries on business through a maritime agent or mediator, with authority in the commercial or operational management of the company's shipping vessels even on a continuous basis, does not give rise to a PE of that company.

This provision should be of no relevance for foreign banks carrying on business in Italy through a PE.

4.2.3. Affiliated companies PE

Article 162(9) of the ITC states that the fact that a non-resident enterprise, with or without a PE in Italy, controls or is controlled by a resident enterprise, or if both are controlled by a third party, shall not of itself turn either enterprise into a PE of the other.

This provision is generally in line with article 5(7) of the OECD Model Convention, although it makes reference to enterprises rather than companies, and therefore seems to have a broader scope.

5. Definition of Permanent Establishment under Italian Double Tax Treaties

Italy has in force an extensive treaty network of 104 double tax treaties and covering both OECD Member and non-Member States (an official list with texts of DTC entered into by Italy is available at www.finanze.gov.it).

Many of the double tax treaties concluded by Italy with OECD Member States are based on the 1963 OECD Model Convention.

Although Italian double tax treaties provisions reflect those of the OECD Model, some general differences may be highlighted:

- the vast majority of double tax treaties concluded by Italy does not deal with building site PE in a separate paragraph, but include them in the list of examples present under paragraph 2;
- the vast majority of Italian double tax treaties do not contain the equivalent version of Article 5(4)(f) of the OECD Model Convention, under which the maintenance of a fixed place of business solely for any combination of auxiliary/preparatory activities shall not, as such, give rise to a PE;
- the majority of the Italian conventions contain a different wording from the one of Article 5(5) of the OECD Model Convention, stating: *"A person acting in a Contracting State on behalf of an enterprise of the other Contracting State - other than an agent of an independent status (...) - shall be deemed to be a permanent establishment of the enterprise in the first-mentioned State if he has, and habitually exercises in that State, an authority to conclude contracts in the name of the enterprise unless his activities are limited to the purchase of goods or merchandise for the enterprise".*

- some Italian tax treaties contain a service PE clause stating that a non-resident enterprise may be deemed to have a PE in Italy (and vice versa), although in the lack of a fixed place of business, if its employees furnish services therein exceeding a certain threshold period.

Italian tax treaty network should be amended by the MLI when applicable, in order to align the covered agreements to the principles contained on the Agency PE notion in Action 7 "*Preventing the Artificial Avoidance of Permanent Establishment Status*" of the OECD BEPS project.

6. Italian official interpretations of the term PE: the *Phillip Morris* cases

The most debated Italian judgment on the notion of PE is the 2002 Phillip Morris case.

As a methodological premise, it must be noted that in a part of its reasoning the Supreme Court clearly stated that the commentaries to the OECD Model Convention do not have any force of law and should be regarded as mere recommendations for OECD countries, not binding for the judiciary. This is an evidence supporting our introductory remark about the infamous uniqueness of the Italian official notions of PE.

In respect of the physical PE notion, the court ruled that the legal and contractual relationships between the various group companies with reference to the activities performed in Italy should not be analysed separately, but should rather be considered as a whole. By doing so, a new proto anti-fragmentation rule was construed years before the BEPS Project was even conceived: the new PE notion was called "multiple PE" of foreign companies belonging to the same group and pursuing a common business strategy. The court adopted a substance over legal form criterion, stressed the relevance of the control of a foreign parent company over its Italian subsidiary and excluded the auxiliary nature of the activities performed by the latter by finding that they were essential to the foreign group's profitability.

The Phillip Morris judgment was an earthquake also with respect to the agency PE notion, even more so considering that Italy has an ancient civil law tradition. In this respect, the Supreme Court established the principle according to which the mere participation of officers – with or without powers of representation – of an Italian company during negotiations of contracts, formally executed by other non-resident companies, should be considered as an authority to conclude contracts in the name of a foreign company. Again, the court stressed the importance of a substance over form approach.

The reaction of the international tax community to the Phillip Morris cases brought to a specific amendment of the 2005 Commentary, in order to take distance from the Italian interpretations: the OECD clarified that for the purposes of determination of the existence of a PE, it is necessary to consider separately each company in a group, and not the group as a whole. At the same time, as mentioned above, Italy made an express observation clarifying that its jurisprudence on the subject is not to be ignored: an original celebration of a *stare decisis* approach for a civil law country.

In recent times, following the important changes to the notions of PE Italy and the international community as a whole is facing, what Phillip Morris case ruled bringing to scandal might well be found to have a new fashionable look.

7. Permanent Establishments of foreign banks in Italy

The banking sector is subject to strict regulatory rules and to specific authorizations.

This chapter does not analyze regulatory issues connected to the performance of banking activities in Italy.

Most commonly, foreign banks establish their presence in Italy by way of representative offices, branches, as well as subsidiaries.

The creation of a representative office or of a branch (or, in some instances of a subsidiary) may imply PE risks, specifically as for the fixed place of business or the Agency PE rule.

Generally, regulatory rules limit the nature of the activities that may be performed in the Italian territory through representative offices of foreign banks. However, when analyzing the existence of a PE in Italy, attention should be given to the activities effectively and substantially performed in the Italian territory, irrespective of whether regulatory rules are being observed. Generally, a potential fixed place used solely for the supply of information, as it may be a representative office, which can in certain instances be considered a preparatory or auxiliary activity of the main activity performed by the non-resident company enterprise, should not give rise to a PE.

Generally, representative office of foreign banks in Italy are aimed at:

- assisting clients in the research for commercial counterparties;
- cultivating potential clients and creating client relationships;
- supporting clients in trade finance activities;
- promotional activities.

However, the preparatory or auxiliary nature of the activities performed by the representative office needs to be considered in the light of facts and circumstances.

Branches, as a matter of principle, are authorized to carry on banking activities in Italy, thus being quite uncommon for a branch not to constitute an Italian PE of the foreign bank. Carrying on investment banking activities may imply the use of servers. OECD Commentary explicitly deals with server PE, clarifying that, in principle, computer equipment physically located in a jurisdiction may constitute a fixed place of business in certain circumstances. In any case it should be evaluated also whether this fixed place of business is “at disposal” of the foreign bank as well as the nature of the activities carried on through such server (i.e. having preparatory or auxiliary nature or not). According to the OECD Commentary, by way of example, activities which are seen as preparatory or auxiliary in electronic commerce operations include:

- providing a communication link (e.g. phone lines) between the bank and the clients;
- advertising of products and services;
- relaying information through a mirror server for security and efficiency purposes;
- gathering market data for the enterprise;
- supplying information.

It is understood that, also in this case, the preparatory or auxiliary nature is to be evaluated in the light of the business carried on by the enterprise. For example, in case of investment banking activities, should the server be used for the trading of securities to be included in the clients’ portfolios, such activity could hardly be qualified as preparatory or auxiliary, forming itself an essential part of the business.

Chapter 2

Attribution of profits to banking PEs and free capital allocation

Giorgio Massa

1. General Considerations

International tax principles for attributing profits to a permanent establishment (hereinafter also "PE") are provided by Article 7 of the OECD Model Tax Convention on Income and on Capital (hereinafter also "OECD Model").

Briefly, Article 7(2) of the OECD Model states that the amount of income to be allocated to a permanent establishment and taxed in the State in which it is located, is equal to profits that it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which the PE is part.

Additional guidance on the interpretation of Article 7(2) of the OECD Model is provided by the OECD "2010 Report on the attribution of profits to Permanent Establishments" (hereinafter also the "OECD Report") as well as by the OECD BEPS Action 7 - March 2018 report titled "Additional Guidance on the Attribution of Profits to a Permanent Establishment under BEPS Action 7". In particular, the OECD Report illustrates the main principles for the application of the aforementioned paragraph 2 of Article 7 of the OECD Model, through an "Authorized OECD Approach".

According to the Authorized OECD Approach (hereinafter also "AOA"), a PE should be treated as a functionally separate and independent entity for the purpose of determining its business profits, and the income attributable to it is the income that it would have earned under the arm's length principle if it was a distinct and separate enterprise from its head office, taking into account the functions performed, assets used and risks assumed.

The main objective of the new Article 7(2) of the OECD Model is to determine how the profits of an enterprise are attributable to a PE. The principle herein adopted is the "functionally separate entity" approach.

2. OECD "2010 Report for the Attribution of Profits to Permanent Establishments"

Fundamental in this discussion is the "2010 Report for the Attribution of Profits to Permanent Establishments" published by the OECD on 22 July 2010 after long discussions, focused on the most preferable approach for the attribution of profits to a permanent establishment.

The Report is structured in the following four parts:

- Part I: General Considerations;
- Part II: Special considerations for applying the Authorized OECD Approach to PEs of Banks; and
- Part III: Special considerations for applying the Authorized OECD Approach to PEs of Enterprises carrying on Global Trading of Financial Instruments;
- Part IV: Special considerations for applying the Authorized OECD Approach to PEs of insurance companies.

Particularly, in Part I, the OECD aims to describe the specifics of the AOA and its application. As a general principle, under the AOA, profits to be attributed to a PE are those that the latter would have earned at arm's length, in particular in its dealings with other parts of the enterprise, as if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and the risks assumed by the enterprise through the PE and through other parts of the enterprise[1].

3. Authorised OECD Approach: a two-step process

In order to apply the Authorized OECD Approach, a two-step analysis is required.

Under Step 1 of the AOA, a functional and factual analysis must be carried out to identify the economically significant activities and responsibilities undertaken by the permanent establishment, treating the latter and the rest of the enterprise as if they were separate entities. This step is based on economic fictions and requires to treat a PE as a separate enterprise *"engaged in the same or similar activities under the same or similar conditions"*[2]. Particularly, the analysis is aimed to identify:

- the functions performed by the PE and the economic characteristics related to the performance of such functions;
- the attribution of risks and economic ownership of assets to the PE, based on the identification of the "significant people functions" connected to those risks and economic ownership;
- the determination of the nature of transactions, called internal dealings, between the PE and other parts of the enterprise; and
- the equity capital and interest-bearing debt that need to be allocated to the PE on the basis of assets and risks attributed to the latter;
- the rights and obligations arising out of the transactions between the enterprise of which the PE is a part and the separate and independent enterprise.

[1] OECD, Report on the Attribution of Profits to Permanent Establishments, 2010, at 12.

[2] Ibid.

This analysis should consider the PE's activities and responsibilities, to the extent relevant, in the context of the activities and responsibilities undertaken by the enterprise as a whole, particularly those parts of the enterprise engaged in dealings with the permanent establishment. The outcome of the implementation of Step 1 of the AOA is the identification of functions, risks and assets to be attributed to the PE as well as the nature of those dealings for which the latter should be remunerated. In fact, if intra-entity transactions are recognized as dealings, they should be treated as transactions between associated enterprises.

Under Step 2 of the AOA, the remuneration of any dealing between the hypothesised enterprises is determined by applying, by analogy, transfer pricing principles. Therefore, Step 2 relates to the pricing, on an arm's length basis, of recognized dealings through:

- the determination of comparability between the dealings and uncontrolled transactions, established by applying the comparability factors set out by OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration (hereinafter also "OECD Guidelines"), both directly (characteristics of property or services, economic circumstances and business strategies) or by analogy (functional analysis, contractual terms), in light of the particular factual circumstances of the permanent establishment; and
- the selection and application, by analogy to the guidance contained in the OECD Guidelines, of the most appropriate method to the circumstances of the case to determine an arm's length compensation for the dealings between the permanent establishment and the rest of the enterprise, taking into account the functions performed by and the assets and risks attributed to the PE.

Under the AOA, the traditional transfer pricing methods, included in the OECD Guidelines, should be applied to remunerate the intra-entity dealings. It is worth clarifying that, as aforementioned, the transfer pricing methods must be selected and used applying, by analogy, the guidance given by the OECD Guidelines; namely, dealings should be priced on an arm's length basis under the assumption that the PE acts independently from the rest of the enterprise of which it is a part.

3.1. Step 1 of the Authorized OECD Approach: functional and factual analysis

As a general principle, the Step 1 of Authorized OECD Approach prescribes a functional and factual analysis, in which the key concept is the one of "significant people functions"[3] and, for the financial sector, the concept of "key entrepreneurial risk taking"[4] (KERT) functions.

In light of the foregoing, it is crucial to carefully analyse the whole context in which the enterprise operates in order to understand which functions performed should be considered. In particular, attention should be paid to functions undertaken within the context of the whole enterprise as well as to its value chain, the relationship with other functions and the responsibility and role of the people undertaking the functions concerned. The OECD Report explains that the functional and factual analysis has the same role within the PE context under Article 7 of OECD Model as the comparability analysis in situations involving associated enterprises under Article 9 of OECD Model.

The functional and factual analysis requires further applications for the purpose of

[3] Id, at 15.

[4] Ibid.

hypothesising the PE as a separate entity. In the OECD Report, a new mechanism is developed for attributing risks, economic ownerships of assets and capital to the hypothetically separate and independent PE as well as the rights and obligations arising from the transactions between the hypothetically separate PE and other parts of the enterprise of which the PE is part[5]. In particular, the AOA establishes the "significant people functions" as a mechanism to attribute risks and economic ownership of the assets. Accordingly, the AOA attributes to the PE those risks for which significant functions relevant to the assumption and/or management (in case of subsequent transfer) of risks are performed by people in the PE. Additionally, it attributes to the PE economic ownership of assets for which the significant functions relevant to the economic ownership of assets are performed by people in the PE[6].

It should be noted that, to allow a proper identification of the significant people functions of an enterprise, it is extremely important to have an in-depth knowledge of the characteristics of the industry.

Attribution of functions, risks and assets

When performing functional and factual analysis, functions performed by the personnel of the whole enterprise, including the PE ("people functions"), should be taken into account. In particular, the significance of the latter in generating business profits should be evaluated and, in case people functions are not merely related to support or ancillary activities, they can be assessed as relevant to the attribution of economic ownership of assets and/or the assumption of risks[7].

The crucial aspect to be taken into consideration when analyzing the significant people functions concept, is the people's ability to take responsibility and decisions. In other words, the PE's personnel capacity of managing resources and competencies in order to take responsibility on risks and on assets used. Hence, significant people functions could be performed only by people having the actual resources and competencies to manage and take responsibility for the PE's risks and assets.

In terms of attribution of assets, the functional and factual analysis will examine all facts and circumstances to determine the extent to which the assets of the enterprise are used in functions performed by the PE as well as the conditions under which they are used. The results may depend upon the type of asset (i.e., tangible or intangible) and the type of business in which the assets are used.

In terms of risks, the functional and factual analysis will attribute the PE any risk inherent in, or created by, the PE's own significant people functions relevant to the assumption of the risk and taking into consideration any subsequent dealing related to the management or transfer of those risks to different parts of the enterprise or other enterprises. The main principle is that, under the AOA, the attribution of risks within the single enterprise will follow from the identification of the significant people functions.

Free capital attribution to a PE

In Part I of the OECD Report, methods for the attribution of capital (including free capital, which is the funding that does not give rise to tax deductible interest expenses) are also set out in order to support functions performed, risks assumed and assets attributed to the PE.

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[5] Id, at 14.

[6] Id, at 14 et seq.

[7] Id, at 25.

Generally speaking, each enterprise requires capital or debt to fund its business activities, to create, sustain and acquire assets and to assume risks associated with its business. While seeking funding for operations, entrepreneurs will make a fundamental choice: borrow funds (debt) or take in new equity. This choice, in terms of funding the enterprise with debt or equity, will have a different impact on earnings, cash flows and taxes. In particular, funding with capital tends to be more expensive than using debts, as it carries more risks for the investors that are not necessarily repaid by the business. Moreover, tax reasons can also be extremely relevant in leading the decision of a multinational enterprise to use loan capital rather than equity in specific cases. Enterprises seek tax optimization and, often, this can be the main factor influencing the use of a particular method of financing.

Under the AOA, the main elements that need to be taken into consideration to determine the amount of free capital are the following:

- the assets attributed to the PE, which are those economically owned by virtue of the significant people functions identified under the functional and factual analysis;
- the risks allocated to the PE based on the significant people functions that are relevant to the assumption of risks performed by PE's personnel.

Once those determinations are made, the AOA identifies various approaches to attribute interest-bearing debt and to determine the applicable interest rate.

The methods examined in the OECD Report for the purpose of capital attribution are summarized below.

i) Capital allocation approach

This approach is based on the allocation of free capital to a PE according to the proportion of assets and risks attributed to the PE by the functional analysis[8]. However, different problems might arise in applying this approach and those can lead to an over or under capitalization of the PE. For instance, when a PE carries on different type of business activities than the one performed by the rest of enterprise, this approach might be inappropriate.

ii) Economic allocation approach

The economic allocation approach relies on the use of economic capital, which is the capital an enterprise needs to have, given its overall risk and return structure, to avoid bankruptcy in a set period of time. According to the OECD Report, this approach can be useful for banks in order to allocate free capital to their PEs since it is based on measuring risks, which should be monitored in financial institutions.

iii) Thin capitalization approach

Under the thin capitalization approach, a PE would be required to have the same amount of free capital that an independent enterprise would have if it were carrying on the same or similar activities under the same or similar conditions in the host country. The aforementioned approach is based on a comparability analysis of the independent entities in order to determine, at first, the amount of funding of the entity disregarding the debt or equity distinction and then, in the following stage, to allocate the funding into the interest-bearing debt or free capital.

[8] OECD, Report on the Attribution of Profits to Permanent Establishments, 2010, at 38.

iv) Quasi thin capitalization - Regulatory minimum capital approach (safe harbour approach)

The quasi thin capitalization approach, or regulatory minimum capital approach, which is the last method mentioned in the OECD Report, requires a PE to have at least the same amount of free capital required for regulatory purposes, as would an independent enterprise operating in the host country[9]. Such approach is more likely to be applied in sectors that are widely regulated as the financial one. However, the implementation of the quasi thin capitalization approach - regulatory minimum capital approach may not provide an arm's length result since it disregards elements of the AOA such as economic ownership of assets and risks attributed to the PE.

Recognition of dealings

In Part I ("General Considerations") the OECD Report also sets out the criteria for the recognition and characterization of dealings between the PE and other parts of the enterprise to which it belongs.

There are several aspects that should be considered for the evaluation of potential dealings. In particular, more detailed analyses are required compared to the case of transactions between associated enterprises (e.g. wider scrutiny of documentation). Hence, it is necessary to set a threshold that needs to be passed before a dealing is accepted as equivalent to a transaction that would have taken place between independent enterprises at arm's length and therefore be reflected in the attribution of profits under Article 7(2) of the OECD Model. The functional and factual analysis must determine whether a real and identifiable event has occurred and should be taken into account as a dealing of economic significance between the PE and another part of the enterprise. In this context, an accounting record accompanied by documentation showing a dealing that transfers economically significant risks, responsibilities and benefits would be a useful starting point for the purposes of attributing profits[10]. However, as stated in the OECD Report, it is crucial that:

- the documentation is consistent with the economic substance of the activities taking place within the enterprise as revealed by the functional and factual analysis;
- the arrangements documented in relation to the dealing, viewed in their entirety, do not differ from those which would have been adopted by comparable independent enterprises;
- the dealing presented in the taxpayer's documentation does not violate the principles of the AOA, for example, by aiming to transfer risks in a way that segregates them from functions.

Once an internal dealing is recognized to exist and, the above threshold has been passed, the OECD requires the determination of the arm's length remuneration of those dealings though the application of transfer pricing methods.

[9] Ibid, at 40.

[10] Ibid, at 19.

3.2. Step 2 of the Authorized OECD Approach: determining the profits of the hypothesised separate and independent enterprise based upon a comparability analysis

Step 2 of AOA focuses on an economic analysis on how to price dealings between a PE and other parts of the enterprise. The determination of the profits attributable to the hypothesised separate and independent enterprise is based on a comparability analysis.

In particular, the AOA requires to compare of dealings between the PE and the enterprise of which it is a part with transactions taking place between independent enterprises. Such analysis must follow, by analogy, the comparability analysis principles illustrated in the OECD Guidelines[11]. The OECD Report provides specific guidance on some commonly recurring dealings that require special attention, such as dealings involving use of tangible or intangible assets and cost contribution agreements.

As for the comparability analysis, the AOA seeks to apply the same factors used in transfer pricing studies to ensure comparability between internal dealings and uncontrolled transactions. The five economical relevant characteristics (or comparability factors) identified in OECD Guidelines, are the following: i) characteristics of property transferred or services provided; ii) functional analysis; iii) contractual terms; iv) economic circumstances; and v) business strategies. With reference to dealings between a PE and the rest of the enterprise of which it is part, due to the inevitable absence of legally binding contracts, as aforementioned, a greater scrutiny of documentation is required and contractual terms will be identified by analogy.

The AOA requires that the recognised transfer pricing methods identified in the OECD Guidelines[12] should be applied to test the arm's length nature of permanent establishments' recognized dealings. In this regard, the OECD Guidelines state that, when evaluating the compliance with the arm's length principle, the internationally accepted transfer pricing methods may be used and the most appropriate one for the specific case should be adopted. In most cases, comparable uncontrolled transaction may be unavailable and therefore the Transactional Net Margin Method will often be used as the best method.

4. Application of the Authorised OECD Approach to Permanent Establishments of Banks

Due to the specifics and the complexity of the financial sector, the OECD Report gives particular guidance on the application of the AOA to enterprises carrying out a banking business through a PE. Part II of the OECD Report not only aims to provide additional guidance on common situations in the banking industry, but also aims to give further support for a consistent interpretation of tax treaties.

Part II of the OECD Report focuses on the so-called "traditional banking activities" (i.e., borrowing and on-lending money) and provides guidance on how the profits from such activities might be attributed to a PE of a bank13.

First, the OECD Report clarifies that for banks, as for other businesses, the attribution of profits to a PE will be determined in accordance with Article 7(2) of the OECD Model.

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[11] OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration, July 2017, Chapter I.

[12] Ibid, Chapter II.

[13] Id., 64. Please note, as stated in the OECD Report, that the term "interest" is intended to have a broad meaning in order to encompass a wide range of receipts and payments in the nature of business profits earned by a bank from borrowing and lending money.

Then, it analyses the peculiar characteristics of the banking sector taking into account functions performed, assets used and risks borne when creating a financial assets or managing an existing financial asset. Last, it illustrates the application of the AOA to a PE of a banking enterprise maintaining the two-step process, illustrated in Part I (General Considerations) of the OECD Report.

4.1. Functional and factual analysis in the traditional banking sector

The starting point to ascertain the profits attributable to PEs operating in the banking industry is the functional and factual analysis. As mentioned above, this analysis aims to identify the functions performed, assets used and risk borne by the PE and it will be performed taking into consideration the specific features of the banking sector.

Attribution of functions, assets and risks in the banking sector

The OECD Report identifies the most important functions of a traditional banking business and categorizes them into two types of functions: i) functions involving creating a new financial asset (loan) and ii) functions performed over the life of an existing financial asset.

Most importantly, the OECD Report adopts the concept of Key Entrepreneurial Risk-Taking functions as a way of attributing assets and risks to the permanent establishment in the banking industry. KERT functions, as defined in the OECD Report, are those that require active decision-making with regard to the acceptance and/or management of individual risks and portfolio of risks. In addition, the OECD Report clarifies that, for a bank, the creation of a financial asset and its subsequent management usually constitute functions related to the management of risks. As a consequence, economic ownership of the financial assets - as well as the income and expenses associated with holding that assets or lending it to third parties - will be attributed to the part of the enterprise performing those functions[14].

KERT functions will be relevant for the attribution of economic ownership of a financial assets, however it is required to make a case-by-case analysis as the results may vary according to circumstances and facts of a specific situation, such as the type of business, product differences or business strategies.

Therefore, in order to determine whether a given activity constitutes a KERT function for a particular enterprise, the analysis must be based on factors such as the type of banking operation or the business model employed.

Assets

Furthermore, the analysis should also examine whether any physical asset or intangible asset have been used. An arm's length compensation will need to reflect not only the functions performed, but also assets used and risks assumed in performing those functions.

In terms of assets, a bank usually uses physical assets, such as branch premises and computer systems. It is commonly accepted that economic ownership of the tangible asset will be attributed to its user.

[14] Ibid, at 66.

Difficulties may arise with regard to the attribution of an intangible asset to a bank. In the banking industry, intangibles, such as marketing intangibles represented by the name, reputation, trademark or logo of the bank, are particularly relevant as they reflect the importance of measuring and optimising the use of capital and monitoring and managing financial risks.

The OECD Report clarifies that the economic ownership of tangible and intangible assets to a banking PE will be attributed to the part of the enterprise performing KERT functions and, consequently, under Step 2 of the AOA, it provides for the attribution, to the same part of the entity, of the income and expenses associated with holding those assets or lending or selling them to third parties.

Risks

In performing a functional and factual analysis in the banking business, it is essential to conduct a proper evaluation of the risks assumed by the entity. This assessment is crucial since the amount and the nature of the risks assumed by an entity play an important role in determining the amount of capital, in particular regulatory capital, which a bank needs to have. In other words, a bank needs capital according to the risks borne since, in case of the realisation of the latter, it will be able to absorb any losses.

Since capital is essential in order to enable banks to assume the risks arising from their business, the functional and factual analysis in such sector should be particularly focused on the examination of the issue related to capital adequacy and attribution of capital.

It is worth noticing that the performances of traditional banking functions constantly lead to the assumption of different types of risks, such as credit risk, marketing risk, operational risk. In addition, risks assumed by a bank from entering into a transaction may not appear in the balance sheet; therefore, every risk borne needs to be evaluated in order to protect the capital of the bank.

In the banking industry, hence, the functional analysis will first determine the KERT functions and subsequently, according to such determination, it will attribute economic ownership of the financial assets and risks related to the location performing those functions. This is because it is the performance of KERT functions that leads to the assumption of the greatest risks and the AOA attributes economic ownership of the income-generating assets to the part of the enterprise performing such functions[15].

However, Part II of the OECD Report is primarily concerned with the attribution of financial assets, since they have a crucial role in the banking industry, and are not covered by Part I. Consequently, in case the PE performs additional (non-KERT) functions, the functional and factual analysis will be carried on as laid out in Part I of the OECD Report, thus it will be based on the concept of significant people functions.

[15] Ibid, at 74.

4.2. Capital and funding

Capital plays a central role in the banking industry since it is required to support the risks assumed by a bank from its customers.

In this context, as clarified by the OECD Report, capital refers to the funds placed at the bank's disposal by investors who are prepared to accept some higher level of risk in respect of their investment in exchange for an economic return which is expected to be significantly higher that the risk-free rate[16].

Capital is needed by a bank, not only to assume risks, but also to fund the creation of financial assets that generate gross income in the form of interest and interest equivalent.

Creditworthiness[17]

In a transfer pricing analysis, creditworthiness assumes an important role since it may affect the ability of a bank to borrow, the rate at which it does so and the gross margin that can be earned.

The OECD Report refers to creditworthiness as the perception by an independent party of the likelihood that the bank will meet its commitments in respect of any contractual obligation it has assumed. Such obligations arise from the borrowing it has made and the investments it has received. Generally speaking, the creditworthiness of a bank is inversely related to the interest rate it pays to its investors (depositors and holders of its debt investments).

In the AOA context, the evaluation of creditworthiness is undertaken by reference to the bank as a whole and not to the individual branches. The reason for this principle is that the whole of the bank's assets and capital are potentially available to meet any claims on the bank since it would not be relevant where the liability leading to the claim is located. Exceptions will apply when the asset is located in a specific jurisdiction that is not available to meet claims outside that specific jurisdiction.

Hence, PEs generally enjoy the same creditworthiness as the enterprise of which they are part.

4.3. Attribution of free capital to PE in banking sector

In Part II, the OECD Report gives particular attention to the capital adequacy requirements and free capital in the banking industry. In fact, to protect and maintain the financial integrity of the financial system, banks are regulated by governments and are required to have a minimum amount of capital, the so-called "regulatory" capital, based on the risks they assume in conducting their business. It is crucial to point out that, for regulatory purposes, there is no need for any free capital to be formally allocated to a PE but this should not affect the attribution of profits for tax purposes.

In order to achieve an arm's length attribution of taxable profit to a PE, the AOA requires the latter to be treated as having an appropriate amount of free capital in order to support the functions it performs, the assets it uses and the risks it assumes. Free capital is defined as the *"capital that does not give rise to a tax deductible return in the nature of interest under the rule of the host country"*[18] regardless of the classification of that capital for regulatory purposes.

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[16] Ibid, at 69.

[17] Ibid, at 70 et seq.

[18] Id, at 35.

More specifically, through a functional and factual analysis, it will be possible to determine the appropriate amount of capital that a PE should have for tax purposes. The determination will be based on the debt-equity characterization rules of the host country.

The amount of free capital is of crucial importance to determine whether, and to what extent, deductions of interest expenses are allocable to a PE according to the debt-equity ratio. Under this approach, a bank is required to have some of its own financial resources that do not require the payment of interest expenses. The amount of free capital will have a large impact on the potential profit a bank can make and the amount of tax it will pay.

As mentioned, the OECD Report explains that, under the Authorized OECD Approach, it is necessary to attribute the free capital to a PE in accordance with the risks it bears by measuring them. However, since measuring risks is a difficult activity and requires flexibility, the OECD Report recognises that a regulatory approach to measure risks could be adopted. In particular, it refers to the possibility to use the "standardised" approach of risk-weighting assets, as set out in the Basel Accords. The OECD Report explains that the internationally accepted regulatory benchmarks of the Basel Committee seem a reasonable proxy for measuring risks under the arm's length principle. It should be clear that the OECD Report also allows the use of a different regulatory approach to measure risks.

Methods to determine the free capital needed

Once risks attributable to the PE have been measured, the OECD Report clarifies that a following step is needed to determine the amount of free capital that should be allocated to the PE in order to support those risks under the arm's length principle.

The OECD Report examines the following methods for capital attribution:

i) Capital allocation approach

According to the capital allocation approach, the PE will be allocated the bank's actual free capital on the basis of the proportion that the risk-weighted assets of the PE bear to the total risk-weighted assets of the entity as a whole (also known as BIS ratio approach). The OECD Report makes clear that the total free capital of the bank should be properly allocated, therefore not limited to the regulatory minimum. In this case, the requirements should be considered on a solo basis and not having regards to the consolidated basis.

ii) Thin capitalisation approach

According to the thin capitalisation approach, the PE will be allocated with the same amount of free capital thatwould have been allocated to an independent banking enterprise carrying on the same or similar activities under the same or similar conditions as the PE. For the application of this approach, the OECD Report requires to perform an appropriate comparability analysis and, if necessary, to make reasonably accurate adjustments to eliminate material differences between a PE and an independent enterprise.

There is no preference over one method or the other, however an arm's length result should be reached.

iii) Quasi-thin capitalisation - Regulatory minimum approach

The quasi-thin capitalisation approach (also known as regulatory minimum approach) is identified in the OECD Report as a safe harbour approach. According to such method, the PE should have at least the same amount of free capital attributed to it, as it would be required for

regulatory purposes for an independent banking enterprise operating in the host country.
Once the amount of capital attributable to a PE has been identified, notwithstanding the method chosen for its calculation, a comparison between this amount and the actual capital allocated by the bank to the PE is needed.
Consequently, when the actual capital allocated to the PE is lower than the arm's length amount, the host country may make appropriate adjustments to the amount of interest expenses claimed by the PE. Such adjustment would then reflect the amount of the bank's capital that is actually needed to support the lending activities of the PE.

5. The Italian perspective

5.1. The AOA in the Italian tax framework

For a long time, the Italian legal framework for the attribution of profits and capital to permanent establishments was not clear, leading to a high degree of uncertainty. The former rules were vague and subject to different interpretations by the taxpayer and the tax authorities, often leading to results in contrast with the OECD principles.

In particular, even in the absence of a clear legal framework, the Italian Tax Authorities had focused their attention on the proper allocation of free capital to a PE, with specific attention to the banking industry. In fact, Italian Tax Authorities have assessed the taxable income of PEs of foreign banks based on the capital inadequacy, in light of the principles set out in the OECD Report. More specifically, the tax authorities have denied the deduction of notional interest, based on the assumption that, in similar circumstances, an independent bank would have had an amount of free capital determined on the basis of assets used, functions performed and risks assumed. As a result, the tax authorities considered bank PEs as over-indebted and the attribution of branch profits as inconsistent with the arm's length principle.

5.2. Law Decree "Internazionalizzazione"

In 2015, the enactment of Legislative Decree 147/2015, the so-called "Decreto Internazionalizzazione" (hereinafter also "Law Decree"), changed the legal Italian legal framework.

The Law Decree introduced several changes in respect of the tax regime applicable to permanent establishments.

First, the Law Decree provided that the attribution of profits to a permanent establishment should follow the AOA, stating that the Italian PE should be treated as a separate and independent entity engaged in the same or similar activities under same or similar conditions, taking into account the functions performed, risks assumed and assets used.

The official recognition of the AOA and the rejection of the force of attraction principles constitute a relevant move towards alignment of the Italian law with the approach suggested by the OECD.

The revised article 152 of the Italian Tax Code ("TUIR") also provides that transfer pricing rules - determined pursuant to article 110 (7) of the TUIR - shall apply also with reference to the transactions between a permanent establishment and its head office, de facto giving relevance to internal dealings.

With reference to the free capital attribution, Article 152 (2) makes a direct reference to OECD standards, by stating that the free capital should be determined for tax purposes in full accordance with the criteria defined by OECD, taking into account functions performed, assets used and risks borne by the PE. The PE must ensure an adequate level of free capital, as established by the OECD, and this computation influences the possibility to deduct interest expenses.

5.3. Implementing regulation

In this regard, in April 2016, the Italian Tax Authorities published a specific regulation ("Provvedimento") aimed to identify the main criteria to be followed for the computation of the free capital allocated to the PE of a foreign bank by making reference to OCED standards. Particularly, Italian Tax Authorities outlined the main technical principles to be followed in order to determine the free capital of a PE in the banking sector, as summarised below:

- the key concept of KERT functions should be used to allocate assets and risks to the PE of a bank. As anticipated above, according to the OECD Report, KERT functions are those that require active decision-making with regards to the acceptance and/or management of individual risks and portfolio of risks;
- the taxpayer can apply authorized OECD methods (i.e., capital allocation or thin-capitalization). However, the application of the capital allocation method is allowed considering the regulatory data on a "solo basis" and not having regards to the consolidated basis data;
- in case the above-mentioned authorized methods cannot be applied, the free capital should be computed through the application of the quasi-thin capitalization / regulatory minimum capital approach. However, the free capital level should not be determined by making reference to the theoretical minimum capital requirements (i.e., 8%) but rather to the effective level of Common Equity Tier 1 (CET1) that Italian banks present (which is generally different from the minimum required).

5.4. Some key-points

Based on the principles stated in the Provvedimento as well as Italian tax authorities' practice, it is possible to highlight the key-points related to the practical application of those methods in Italy.

In order to attribute risk to the banking PE:

- in determining the BIS ratio in the application of capital allocation, risk-weighted assets need to be determined in a consistent and homogeneous way, adopting the same methodologies actually utilized by the banking entity (e.g. internal model implemented by the bank). Moreover, when determining the Free Capital to be allocated, regulatory capital only relating to the banking entity of which the PE is a part should be considered (solo basis), rather than consolidated regulatory capital;
- in case of quasi-thin capitalization / regulatory minimum capital approach (safe harbour approach), Italian Regulatory framework issued by Bank of Italy ("Regulatory Rules") should be applied.

In line with the applicable regulatory framework, the risk-weighted assets (hereinafter

also "RWA") should be computed by applying the risk-weighting ratios set out in the regulatory rules. As a general principle, the standard method for determining the RWA of the PE may be applied as well as the Internal Rating Method (basic or advanced, assuming that such method is validated by the head office Country). Where the head office does not apply an Internal Rating Method or it is not able to provide detailed supporting documentation to the determination of the PE's RWAs, these should be determined, in case of quasi-thin capitalization, in accordance with the standard method set forth in the Bank of Italy's Regulatory Rules. Conversely, when the Internal Rating Method is applied and duly evidenced, Italian Tax Authorities should accept the application of the temporary rules (the so called "Floor").

When determining the RWA related to the credit risk: (i) the value of the credit risk associated to off-balance sheet transactions should be included in the calculation; (ii) the loans and any exposure with related parties should be ordinarily risk-weighted (i.e., risk-weighted as loans to independent borrowers), (iii) transactions with the head office should be excluded.

The computation of the free capital should also include the amount of capital related to the intangible assets, as well as investments in subsidiaries, according to the application of the relevant Regulatory Rules.

In order to apply the quasi-thin capitalization / regulatory minimum capital approach, the minimum free capital should be computed making reference to the average of Common Equity Tier 1 (CET1) ratio of Italian large banking groups. This average value is contained in the statistical tables attached to the yearly reports issued by the Bank of Italy.

The minimum free capital amount should be compared with the amount of free capital already attributed to the branch ("actual free capital"), calculated considering all items not generating negative deductible components. Thus, the amount should be computed with reference to the entire year, rather than to the year-end. Accordingly: (i) yearly increase of the free capital should be pro-rated over time; (ii) profits related to the previous fiscal year should be considered as part of the free capital until actual remittance; (iii) profits of current fiscal year should be considered when they were effectively derived. In the absence of significant fluctuations, profits should be considered as having been accrued progressively (linear approach, 1/12 per month).

Any deficit in the free capital should result in a disallowed interest expenses amount. To compute this amount, the Italian Tax Authorities may consider the use of a 12-month Euribor or, alternatively, the effective interest rate applied by the PE on intra-group loans received during the relevant fiscal year (i.e., actual cost of funding).

5.5. Conclusion

It should be noted that the practical application of the principles set out above, as well as the consensus of those criteria, is still debated and under analysis by the Italian Tax Authorities. In fact, both taxpayers and professionals are waiting for a Circular Letter aimed at clarifying some relevant points (e.g. the treatment of the investments in subsidiaries and the allocation of capital other than "free" capital, e.g. Tier 2 capital / subordinated debt).

Chapter 3

Accounting (IAS/IFRS) & introduction to business income

Dario Sencar | Giovanni Falsitta

1. Reinforced derivation

Foreign banks operating in Italy through a permanent establishment are required to prepare their balance sheets and statement of comprehensive income (profit and loss - "P&L" - and other comprehensive income - "OCI") in accordance with the international accounting standards (IAS/IFRS adopters) and prudently under the guidelines provided by the Bank of Italy with Circular n. 262 of 22 December 2005 of the Bank of Italy (Circular 262/2005).

In addition, detailed rules on the computation of the taxable income of IAS/IFRS-adopters are contained in Ministerial Decree of 4 April 2009, which adopted and coordinated the norms laid down by Law n. 244/2007, and in Ministerial Decree of 8 June 2011 – respectively "IAS Decree n. 1" and "IAS Decree n. 2".

Accordingly, foreign banking PEs apply the same tax rules provided for resident IAS/IFRS adopters, such as Italian banks.

Corporate income tax ("CIT") is levied on a tax base determined by adjusting the profit and loss accounting result (s.c. "derivation principle"). The adjustments provided by the Italian Income tax code ("ITC")[1] are often applicable to specific categories of taxpayers identified by reason of the adopted accounting principles (i.e. Italian GAAP or IAS) or the performed business (e.g. many rules are specific to the banking industry).

Law n. 244/2007 introduced the "reinforced derivation principle" (see article 83 of the ITC) according to which the criteria provided under IAS/IFRS for qualification, timing accrual and classification of income and cost items apply also for corporate income tax purposes and prevail over any provisions contained in the ITC. However, certain exceptions to the reinforced derivation principle, as better explained below, still apply with particular reference to financial instruments.

In essence, the reinforced derivation principle confirms the prevalence of a "substance over form" approach also for tax purposes. This means that in the case of supply of goods, for example, if the goods are just formally transferred and there is not substantial transfer of risks and rewards linked to the ownership, these goods remain allocated in the supplier's balance sheet.

[1] Presidential decree n. 917 of 22 December 1986.

The prevalence of substance over form is concretely realized through the application of the following IAS/IFRS pillars:

- **Qualification** that comes directly from the interpretation of facts, acts and legal transaction determining the business operation. Based on the scheme identified by international accounting principles, it is possible to verify if and how the qualification of the item generates cash flows for the bank, which will be relevant for tax purposes.
- **Accrual principle** related to the identification of the fiscal year during which income components shall be taxed or deductible.
- **Classification** that identifies the specific type or class of income or obligation linked to each operation as qualified in IAS representation.

Conversely, IAS adopters shall apply ITC rules about evaluations and quantifications, such as provisions limiting amortizations, depreciations, and provisions, as well as those derogating from the accounting principles for purely fiscal reasons.

More specifically, the rules providing for the allocation of revenues and expenses on a cash-basis rather than accrual-basis (e.g. default interest, directors' fees, dividend payments), for the allowance or the limitation of cost deduction or for the taxation of positive components over more fiscal years (e.g. certain capital gains), prevail over accounting principles.

In addition, the ITC provides for derogations addressing specific coordinative dispositions. Indeed, IAS Decree n. 2 has been issued in order to coordinate general tax provisions with the specific taxable income determination rules addressed to IAS adopter.

One of the most relevant provisions is the inclusion of items of income allocated to Equity and Other Comprehensive Income (OCI) in the taxable income. According to this provision, income items are generally tax relevant not only when they are in the P&L but also when they are recognized in the equity or in the OCI section.

Notwithstanding the above, some provisions of the ITC expressly provide that an item of income is only relevant when booked in P&L, therefore the recognition in the OCI is temporarily not tax relevant in certain cases.

Finally, it is worth highlighting that tax relevance of the reinforced derivation principle is based on the assumption that international accounting standards are correctly applied also with regard to factual elements concerning concrete cases and taking into account data and information available at the moment of drafting the financial statements.

2. PE taxable income

The Italian legislative framework regarding permanent establishment of foreign entities (hereinafter also "PE") has been modified by Legislative Decree No. 147/2015 (hereinafter also "the Decree"). In brief, under revised Italian Income Tax Code (so-called TUIR - or "ITC") (see art. 152 ITC):

(i) a PE's taxable income has to be determined considering profits and losses deriving only from its effective activity and determined by applying the rules set for Corporate Income Tax (so called - IRES) subjects, in application of the OECD functionally separate entity approach;

(ii) consistently with the functionally separate entity approach, a PE's taxable income is determined starting from a specific financial statement drawn up under the same accounting standards applicable to Italian companies carrying out similar business. Thus, the provision requires[2] Italian PEs of foreign banks (starting from January 1, 2016) to draw up financial statements (B/S and P&L) under IAS/IFRS principles (i.e. accounting principles to be applied by Italian banks[3]) for tax purposes.
From an accounting point of view, until December 31, 2015, PE of foreign banks could chose to adopt either the accounting principle of their Head Offices or the accounting principles permitted by Italian Legislation. Starting from January 1, 2016, this possibility is prevented by the ITC (art. 152). This means that for an Italian PE of a foreign bank, the accounting standards should be only the IAS/IFRS principles[4];

(iii) a PE must have a proper branch capital, determined in line with the OECD approach, considering the activities carried out, the risks assumed and the assets utilized[5];

(iv) transactions between a PE and its Head Office must be compliant with transfer pricing rules under article 110(7) ITC.

The mentioned revised provisions have significant impact on the tax rules applicable for the determination of PE taxable income for IRES (and also for IRAP[6]) purposes.

3. Corporate tax and banking surcharge

The Budget Law 2016 (so called "Legge di Stabilità 2016") provided for the reduction of the IRES tax rate from 27,5% to 24% starting from the fiscal year following the one current at December 31, 2016 (i.e., 2017 for companies having the FY coincident with the calendar year).

Moreover, the same Budget Law has introduced an additional IRES tax rate equal to 3,5% for the banks and other financial entities ex art. 1 of Legislative Decree no. 87/92. The Budget Law 2018 extended the application of the additional rate also to brokerage firms.

In case of tax consolidation regime (ex art. 117 of the Income Tax Code), the additional tax rate is applied on the individual basis for each participating company.

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[2] On this regard, please note that no specific provision regarding accounting principles to be applied by PE of foreign banks could be found in the Italian Legislation (except of art. 2508 Civil Code related to mandatory accounting book).

[3] Legislative Decree No. 38/2005 introduced an obligation, also applicable to banks, to adopt as accounting principle, starting from 2005/2006, the IAS/IFRS accounting standards. However, PE of UE and extra UE banks were not obliged under Legislative Decree No. 38/2005 to adopt such accounting principles considering the absence of the registered office in Italy.

[4] As a consequence, PE of foreign banks which did not adopt until December, 31, 2015, IAS/IFRS accounting standards, had to make IAS/IFRS transition, with subsequent effects for IRES and IRAP purposes.

[5] The correct computation of branch capital is relevant, as described in Part 2 - Chapter 6, for the ACE deduction and also for the possibility to convert, at certain conditions, DTAs into tax credits (as described in this Chapter).

[6] Legislative Decree No. 147/2015 also introduced a provision applicable for Regional Tax on Productive Activities (IRAP). Starting from fiscal year 2016, Italian PEs are required to prepare the income statement and the balance sheet according to the accounting principles that would have been adopted by Italian resident entities carrying out a similar business. Consequently, for the correct determination of IRAP, a PE carrying out banking activities in Italy shall adopt IAS standards and prepare financial statements as provided by the Provision of the Bank of Italy.

4. Group taxation regime

Entities belonging to the same group can opt for domestic tax consolidation. This regime allows the determination of a single CIT base given by the sum of the taxable income and losses of each of the participating entities. Tax consolidation does not operate for purposes of the Italian Regional tax.

The overall tax loss position could be carried forward and used to offset consolidated taxable income of the subsequent periods. Conversely, tax losses suffered during the fiscal years preceding the consolidated tax election could be carried forward and used only by the company to which these losses belong. It is necessary to point out that, as general rule, the ITC provides that the taxable income can be offset up to 80%, regardless of the total amount of the available losses.

The tax base determined by each company participating in the tax consolidation regime is included in its entirety: no apportionment is made in relation to the percentage of control.

The election for the group taxation regime implies the following benefits:

- The possibility to offset the taxable income with the losses arisen during the period of validity of the group taxation regime;
- More chances to use the foreign tax credit (based on a per-country and a per-company approach);
- The deductibility of NID (ACE) surpluses from the group tax income.

In general, tax consolidation regimes allow participants to apply for the limitation rules on interest deductions on a common basis, so that – differently from a stand-alone basis taxation - the group entities within the tax consolidation perimeter could benefit from thresholds calculated on higher group ratios. However, specific rules provided for the financial industry could imply different benefits in relation to the entity included in the group taxation regime.

As a matter of fact, (i) banks no longer suffer limitation rules starting from the fiscal year 2017, (ii) insurance companies and management companies of common funds can deduct 96% of interest expenses, and (iii) non-financial entities have to apply the ordinary rules providing a threshold on the basis of the operating income.

In light of this, if the group taxation regime includes all entities referred to points (i), (ii) and (iii) above, the benefits related to the group deductibility of the interest expenses could be summarized as follows:

- insurance companies and management companies of common funds constitute a sub-part of the consolidation regime, within whose perimeter the total amount of interest payable to entities part of the sub-consolidation are fully deductible up to the total amount of the interest payable due to entities outside the consolidation;
- other non-financial entities calculate the operating income for determining the threshold for interest expenses deduction on a common basis method, so that the group threshold is often higher than if it is calculated on a stand-alone basis.

In addition to the obligation to notify Italian Tax Authority the election for the regime and for the group domicile (that should be the consolidating entity domicile), the group taxation regime requires that the following conditions are cumulatively met:

- The consolidating entity can be
  a. an Italian tax resident company or,
  b. an Italian branch of a foreign company i) resident in countries that have a Double Tax

Treaty with Italy and ii) performing an active business through the permanent establishment.

- The consolidating entity has to hold, directly or indirectly, the majority of the voting rights that can be exercised at the shareholders' meeting or more than 50% of the subsidiary's stated capital or it must be entitled directly or indirectly, to more than 50% of the subsidiary's profits (the "Control");
- All of the entities participating in the group must have the same FY;
- The Control must be in place from the beginning of the first FY to which the tax consolidation is applied;
- Domestic tax consolidation election must be made jointly by the parent company and by each subsidiary and it must be exercised in the tax return filed in the first FY to which the consolidation applies;
- Each subsidiary must elect its domicile for tax purposes at the domicile of the parent company.

The consolidation regime operates on an elective basis. Taxpayers may decide whether to be included or not, and it is not necessary for all the Italian group/sub-group companies to make a joint election. Once the election is made, it cannot be revoked for three FYs.

Under the pressure of the European Court of Justice, the Italian legislator, starting from 2016, has introduced the "horizontal group taxation regime".

Under this regime, a foreign parent company resident in EU/EEA countries having an exchange of information agreement with Italy without a permanent establishment in Italy can elect an Italian or foreign subsidiary (through its Italian permanent establishment) as consolidating company. The group taxation regime can include the Italian and the foreign subsidiaries of the electing foreign parent company other than the subsidiaries participating the elected consolidating entities.

The election requires the following steps:

1. the EEA parent company must obtain an Italian tax identification number from the tax authorities;
2. it must designate one of the Italian sister companies to opt for the tax consolidation regime and to act as the consolidating entity;
3. the sister company or the permanent establishment chosen as consolidating entity must opt for the tax consolidation regime by filing another form with the tax authorities.

The application for the group taxation regime is regulated by a specific "tax consolidation agreement" made between each consolidated company and the consolidating company or entity. Such agreement shall discipline:

i) money transfers resulting from the group taxation regime obligation among the companies involved;
ii) methods for determining the financial compensation of tax losses, interest surpluses, ACE deduction; and
iii) the consequences of the interruption of group taxation before the end of the three-year period or in the case of non-renewal.

In this regard, it is worth highlighting that the amounts received or paid under the consolidation regime are not relevant for tax purposes and the methods for the loss allocation, within the limits of the applicable law, can be regulated by the entities part of the regime. If at the end of the regime no method is provided, losses will only be available to the consolidating entity.

Chapter 4
Credits

Alessandro Catona | Gabriella Forza

A provision particularly significant for the banking industry is the tax regime on receivables, which is (also) applicable to PEs of foreign banks, both for IRES and IRAP purposes.

As an introduction to the topic, please find below an overview of the applicable "tax framework" which takes into account the various amendments to such provisions occurred in recent years.

1. Evolution

1.1. Tax regime applicable until FY 2012 – relevant only for IRES purposes

Until FY12, only for IRES purposes, there were two different tax regimes applicable, respectively, to losses on receivables (write-off) and to receivables' specific provisions (write downs), net of write backs.

In particular, write-offs, when meeting the certainty and precision requirements, were entirely deductible in the fiscal year in which they were accounted (in case of assessment, tax Authorities may verify the presence of such certainty and precision requirements). Differently, write downs, net of write back, were entirely deductible within the limit of the 0,3% of the total amount of the credits accounted in the balance sheet; the exceeding amount was deductible in equal instalments over the subsequent 18 fiscal years.

If the amount of write downs was lower than the above mentioned limit, a generic provision to credit risk reserve (bad debt provision) was allowed within the same limit (the sum of write downs, net of write back, and generic provision could not exceed the 0,3% limit). The provision exceeding the 0,3% limit was not deductible for IRES purposes. The credit risk provision not exceeding the 0,3% limit, had to be utilized in case of credits' write off deductible for IRES purposes (i.e. respecting certain and exact elements under article 101, ITC), irrespectively of the accounting approach adopted. When accounting principles impose the utilization of the credit risk provision (e.g. in case of credits' write off not respecting certain and exact elements of deductibility or provisions' release) it should be considered firstly linked to the part not deducted for IRES purposes.

On this regard, Italian banks could not have credit risk provision in their F/S (considering the IAS/IFRS transition) but eventually only (for tax purposes) in their tax returns. However, it was allowed to Italian PEs of foreign banks adopting ITA GAPP which had not yet performed (until FY2015) the IAS/IFRS transition.

Receivables write downs and write offs were not deductible for IRAP purposes: only losses on sale for consideration were deductible from the taxable base of the regional tax.

1.2. Tax regime applicable for FYs 2013-14 - relevant both for IRES and IRAP purposes

Law No. 147/2013 (so called "Legge di Stabilità 2014") introduced significant amendments to the above-described rules. Effective from FY 2013, client receivables' specific provisions (write downs) and losses (write-offs, different from those realized through credit sale for a consideration), net of write-back were deductible for IRES and IRAP purposes in equal instalments in the fiscal year in which they were recorded in the P&L and over the subsequent four fiscal years.

Receivable losses realized through sale for consideration were fully deductible in the fiscal year in which they were recorded in the F/S (no certainty and precision requirements had to be met).

However, write downs (net of write backs) accounted in the P&L account of previous FYs were still subject to the previous tax regime (i.e. deductibility in equal instalments over the subsequent 18 fiscal years).

As a consequence of the new regime, starting from FY 2013, the generic provision to credit risk reserve (bad debt provision) deductable for IRES purposes (by banks and other financial intermediaries - including PE of foreign banks) within the 0,3% limit was repealed. Moreover, this new amendment does not clarify how the credit risk reserve should be utilized.

On this regard, the Italian Tax Authority ("ITA") clarified, with Circular Letter No. 14/E 2014, that, consistently with the previous regime, bad debt provisions deducted for IRES purposes shall be utilized in case of losses on receivables: i) realized through credit sale for a consideration or ii) deriving from the recognition of credits deductible under article 101(5) ITC (i.e. different from clients' receivables). ITA clarifications seems to identify only the scenarios in which the utilization of the credit risk provision is mandatory, leaving some residual uncertainty. In particular, it is not clear if the credit risk provision could be used also in case of write-offs different from those realized through credit sale for a consideration. On this regard, in case the accounting principle (i.e. IAS/IFRS) imposes the utilization of the credit risk provision, such utilization should have relevance also for tax purposes (especially in the light of the principle of direct derivation of IRES tax basis from the financial statements applicable for IAS/IFRS adopters).

From an IRAP perspective, considering that no credit risk provision was deducted in the past, the related utilization should be also excluded[1].

However, considering the relevance and the materiality of the question (also for PE), further clarification by ITA seems to be necessary.

1.3. Tax regime applicable for FY 2015 ("transitional regime"), FY 2016 and subsequent FYs ("new regime") - relevant both for IRES and IRAP purposes

Law Decree No. 83/2015 (art. 16) further modified the tax treatment applicable to receivables from customers write-downs for banks and other financial entities both for IRES and for IRAP purposes.

Starting from FY 2015 (for companies having a fiscal year that matches the calendar year), such Decree provides also for the full deduction of receivables' write-downs in the fiscal year

[1] Consistent with this interpretation is the ITA's Circular Letter n. 12/E February, 19, 2008 regarding costs covered by risks and charges items.

in which they are booked in the P&L. In this respect, write-downs have to be assumed net of write-back (revaluations) performed in the fiscal year.

Nevertheless, it provides for a transitional regime for the first year of application (i.e. 2015), according to which net write-downs deduction is limited to the 75% of their overall amount booked in the P/L. Also in this case, write downs (net of write back) and losses accounted in the P&L account of previous FYs are still subject to the previous tax regime (i.e. either deductibility in equal instalments over the subsequent 18 fiscal years or deductibility in equal instalments over 5 fiscal years).

Moreover, the Decree provides that both for IRES and IRAP purposes:

(i) write-downs reversals not deducted at December 31, 2014 (under the previous receivables' regime) and

(ii) the 25% of write-downs whose deduction is not allowed in FY 2015 (under the transitional regime) will be deductible in 10 years starting from the FY following the one current at December 31, 2015 (i.e. 2016 for companies having the FY coincident with the calendar year), with increasing percentage of deductibility (ranging from 5% to 12%[2]).

On this regard, also the provisions applicable starting from FY 2015 do not clarify how the credit risk provision (related to the tax regime applicable until FY 2012) should be utilized by banks and other financial intermediaries. However, the above described clarifications, gave by ITA in Circular Letter No. 14/E 2014, should be considered also applicable to the receivables' tax regime under Law Decree No. 83/ 2015 starting from FY15 (as hereinafter described). Thus, it should be supposed that, for FY15, only losses (different from those realized through credit sale for a consideration) exceeding the credit risk provision are subject to the transitional regime of deductibility.

Moreover, even if the utilization of the credit risk provision could not be considered relevant for tax purposes, the related release of the provision would be considered as a write-back and thus, there would be the same impacts on IRES taxable basis.

Net write downs not entirely deductible in the past fiscal years (i.e. whose deductibility were postponed to subsequent fiscal years), generated temporary differences for IRES and IRAP (only starting for FY 2013) purposes, on which companies could have registered in the F/S deferred tax assets (DTAs).

[2] Indeed, from fiscal year 2016 will be fully implemented the following system of deduction:
- 5% of the amount in fiscal year 2016;
- 8% of the amount in fiscal year 2017;
- 10% of the amount in the fiscal year 2018;
- 12% of the amount from fiscal year 2019 to fiscal year 2024;
- 5% of the amount in fiscal year 2025.

The table below summarizes the described tax treatment applicable to receivables from customers' write-downs.

FYs	IRES*		IRAP*	
	Amount deductible in the accounting FY	**Amount deductible over subsequent FYs**	**Amount deductible in the accounting FY**	**Amount deductible over subsequent FYs**
until 2012	Write downs (net of write back) not exceeding 0,3% of the total amount of credits: entirely deductible in the accounting FY.	Write downs (net of write back) exceeding 0,3% of the total amount of credits: deductible in equal instalments over subsequent 18 years.	N/A	N/A
2013/2014	Write downs and write off (net of write back): deductible for 1/5 of their entirely amount in the accounting FY + Receivables' losses realized through sale for a consideration: entirely deductible in the accounting FY.	Write downs and write off (net of write back): deductible for 4/5 of their entirely amount in equal instalments over subsequent 4 years.	Write downs and write off (net of write back): deductible for 1/5 of their entirely amount in the accounting FY + Receivables' losses realized through sale for a consideration: entirely deductible in the accounting FY.	Write downs and write off (net of write back): deductible for 4/5 of their entirely amount in equal instalments over subsequent 4 years.
2015	75% of write downs and write off (net of write back): deductible in the accounting FY.	25% of write downs and write off (net of write back): deductible in 10 years starting from FY2016 with increasing percentage.	75% of write downs and write off (net of write back): deductible in the accounting FY.	25% of write downs and write off (net of write back): deductible in 10 years starting from FY2016 with increasing percentage.
2016	100% of receivables' write-downs: deductible in the accounting FY.	N/A	100% of receivables' write-downs: deductible in the accounting FY.	

*tax regime applicable to credits write downs accounted in each FY

2. DTAs conversion into tax credits

The above described provisions applicable to credit write downs, have relevant impact for the conversion into tax credit of DTAs booked in the F/S.

In fact, according to Law 214/2011 and subsequent amendments, DTAs related to credit write-downs and write offs, as well as to goodwill and intangible assets (only in relation to the part of DTAs booked before FY 2015), may be converted into tax credit, under certain conditions. The aim of the provision is to allow Italian banks and financial intermediaries to overcome the competitive disadvantages in respect of other European banks related to the high amount of DTAs in their balance sheets and to guarantee a better regulatory capital level to banks and other financial intermediaries (in fact, DTAs potentially convertible into tax credits are not deducted from the regulatory capital).

The conversion is mandatory for banks and financial entities (weather is optional for the others entities subject to IRES and IRAP), to the extent that the relevant conditions are met.

With regard to the application to PEs (including PEs of foreign banks), the provision does not specify anything. However, the ITA clarified with Circular Letter No. 37/E 2012 that the conversion of DTA in tax credit is also applicable to foreign entities which operate in Italy through a branch under art. 162 TUIR and, in respect to art. 152 TUIR, determine the income tax basis on the basis of a profit and loss related to branch's management[3].

Generally, the conversion is triggered if the company realizes: (i) a loss in its F/S; or (ii) a tax loss for both corporate IRES and for IRAP purposes and it is also possible if the company is under voluntary winding-up or insolvency proceedings. Different rules apply for conversion mechanism, depending on the kind of loss realized by the company. As a matter of fact, the provision was originally introduced only for IRES purposes by Law Decree No. 225, of December 29, 2010 subsequently amended by Law Decree No. 201 of December 6, 2011, extended to IRAP by the 2014 Financial Bill (i.e. Law No. 147, of December 27, 2013) and further amended by Law Decree No. 83 of June 27, 2015.

2.1. Conversion in case of accounting loss and in case of voluntary winding-up or insolvency proceedings

In case of an accounting loss (point (i)), the conversion starts from the F/S approval date and operates in a measure equal to the ratio between accounting loss and equity.

From the tax period in progress up to the date of approval of the financial statement, the negative components corresponding to the DTAs converted (such as reversal of write downs or amortizations) are no longer deductible from the taxable income.

The part of the provision which refers to the F/S approval could generate some doubts in case of a PE, considering that it does not have similar obligations. In particular, it is not clear if for a PE reference should be made to Head Office's F/S approval or not (also considering that the profit/loss of the period could be significantly different). In this regard, there is no clarification from the ITA.

However, ITA specified in Circular Letter No. 37/E that for PEs the conversion calculation has to be performed considering:

[3] Considering that PEs of foreign banks are not generally obliged to respect certain regulatory provisions of the Bank of Italy and that the F/S approval is referred to the Head Office's F/S, the application of the conversion also to PEs could be considered only a matter of "homogeneity". However, it should also be verified if in the Head Office's home country (especially UE countries) has a similar provision which requires, at certain condition, the conversion of DTAs into tax credit.

(i) the accounting loss as resulted from the P&L relevant for tax purposes (under "revised" art. 152 ITC);
(ii) DTAs booked in the accounting of the PE, to be kept under art. 14 of Presidential Decree No. 600/1973. For PEs, the ITA allows the conversion into tax credits for accounting items which represent DTAs under Italian Legislation, but not necessarily in the Head Office's F/S. This relevant clarification seems to lead to a wide interpretation of the DTAs conversion rule for PEs.
(iii) the equity corresponding to the "figurative" free capital, as resulted from the PE Income Tax Return. Thus, for PEs the equity relevant for the conversion is not the equity book value of the free capital but the proper branch capital relevant for tax purposes (according to OECD principles)[4]. This difference (in respect of the calculation for resident companies, performed considering the book value of the equity) could potentially lead to different results in term of conversion, not exactly in line with the rationale behind the provision.

Moreover, different effects could also arise in case of voluntary winding-up or insolvency proceedings when the conversion should be calculated with regard to DTAs booked in the last approved financial statements before the procedure and could be performed only at the end of the procedure. In fact, in this scenario, the ITA clarified that PEs are excluded from the application of the conversion rule, considering that voluntary winding-up or insolvency proceedings are necessarily linked to the Head Office. Thus, PEs whose activities are closing in Italy could not benefit from the conversion, even if all other conditions required are met.

In conclusion, even if in some circumstances PEs could suffer certain limitations in the application of the conversion provisions, its own possibility to access such provisions could lead to wider advantages.

2.2. Conversion in case of tax loss

If the company realizes a tax loss, DTAs are convertible into tax credit only for the portion of the loss generated by the reversal of write-downs of credits/goodwill amortization and impairment of other intangible assets. In this case, the conversion starts from the date in which the tax return is filed. Subsequently, tax losses to be carried forward will be reduced by the amount of the aforementioned deductions related to the converted DTAs.

Starting from FY 2013 this regime (previously allowed only for IRES) was extended to IRAP. In case of negative IRAP taxable base, IRAP DTAs on credits' write down and amortization can be converted.

For PEs, ITA clarified in Circular Letter No. 37/E 2012 that for DTAs conversion is relevant the tax loss resulted from the PE Income Tax Return.

[4] Considered also by ITA for the application of other provisions, such as Allowance for Corporate Equity (ACE) or provisions aimed to avoid under-capitalization of the branch through passive interests deduction limitation.

2.3. Use of the tax credit deriving from DTAs conversion

The tax credit arising from DTAs transformation can be either used to offset the payment of taxes and contributions without any limit in terms of amount or deadline, transferred at its nominal value, within the same group or claimed for refund. This latter provision seems to be residual, because the opportunity to request a refund credit is subject to the execution of all the possible off-setting and, as mentioned above, there are no limits to use such credit. This means that the possibility to request the credit refund should be made only in certain cases, e.g. in case of winding up of a company).

2.4. Amendments to receivables' write-down deductibility for IRES and IRAP purposes - impact on DTA's conversion

The provisions introduced by Law Decree 83/2015 in respect of clients receivables write-downs deduction impacted, although indirectly, the DTA's conversion into tax credit from 2015 onwards. In fact, it modified both IRES and IRAP tax treatment applicable to credit write-downs for banks and other financial entities.

In particular, these new provisions:

(i) did not affect the conversion (at certain conditions) into tax credit of the DTAs booked on receivables write-down not deducted as of December 31, 2014;

(ii) allowed the conversion into tax credit of DTAs booked on the 25% of write-downs, whose deduction was not allowed in FY2015;

(iii) prevented the generation of new DTAs potentially convertible into tax credits (as from 2016, credit write-downs are fully deductible on an accrual basis and considering that, according to Law Decree No. 83/2015, also DTAs on goodwill generated from 2015 onwards ceased to be convertible).

Moreover, the connection between the provisions concerning the conversion into tax credits of the DTA booked on receivables' write-downs and the new mechanism of receivables write-downs deductions postponement (over 10 years with increasing percentage of deductibility ranging from 5% to 12%) is not clear at the moment, especially in respect to reversals recovery after conversion.

In the absence of clarification from the ITA, for the 10 years deduction plan, there could be two different scenarios:

i) a "close balance" method, under which receivables write-downs as of December 31, 2014 and 25% of write-downs whose deduction is not allowed in FY2015, should be considered net of the conversion into tax credit of DTAs (i.e. after the reversal sterilization deriving from the conversion). On such net amount, the increasing percentage of deductibility could be applied;

ii) an "open balance" method, under which receivables write-downs as of December 31, 2014 and 25% of write-downs whose deduction is not allowed in FY2015, should be considered, at first, with giving no relevance to reversal sterilization (deriving from DTAs conversion). On this gross amount it should be applied the increasing percentage of deductibility, reduced, then, each year, by reversal sterilization deriving from the DTAs conversion up to their entire (annual) amount.

The above described methods could have different impacts on IRES and IRAP tax bases. However, in absence of the (necessary) clarification by ITA, both of them could be considered acceptable.

2.5. Annual commission payment for convertible DTAs

According to the European Commission, DTAs conversion into tax credit could be considered in breach of State Aid rules to the extent that the convertible DTAs do not correspond to an actual advance payment of taxes. In order to comply with European Commission remarks on the matter, an optional regime was introduced by article 11 of Law Decree 59/2016. Under such regime, the conversion rule is still applicable also to DTAs not corresponding to an actual advance payment of taxes, only to the extent the company opts for an annual commission computed on convertible DTAs generated from 2008 onwards to be paid from 2015 until 2029.

In the light of the above, for the purposes of determining such commission, the provision identifies two different kinds of convertible DTAs:

(i) convertible DTAs corresponding to an actual advance payment of taxes - i.e. the amount of convertible/converted DTAs do not exceed the amount of taxes paid in the same period of time - **(DTAs 1)**;

(ii) convertible DTAs not corresponding to an actual advance payment of taxes - i.e. the amount of convertible/converted DTAs exceeds the amount of taxes paid in the same period of time - **(DTAs 2)**.

Should the option not be exercised, DTAs 2 will cease to be convertible. Consequently, DTAs 2 may be deducted from the regulatory capital according to Basel III framework for banks and financial entities.

DTAs 1, in any case, will still be convertible, thus being fully included in banks' regulatory capital.

2.6. Annual payment

The commission is equal to 1,5% of the difference, if positive, between convertible DTAs and taxes paid.

$$\text{Commission}=(\text{DTAs}_c - \text{Taxes paid})\times 1{,}5\%$$

Where:

DTAs_c are made up of:

(i) the difference between:

a. convertible DTAs in the F/S [$\text{DTAs}_{c\ \text{Dec 31, x}}$];

b. convertible DTAs in the F/S as of Dec 31, 2007 [$\text{DTAs}_{c\ \text{Dec 31, 2007}}$];

(ii) DTAs converted into tax credit [DTAsc credit].

Taxes paid include:

(i) IRES and additional IRES paid in relation to years 2008 and following [$\sum^{x}_{i=2008}$ *(IRES+additional IRES)*];

(ii) IRAP paid in relation to years 2013 and following [$\sum^{x}_{i=2008} IRAP$];

(iii) Substitute taxes paid from 2008 up to 2014 for the step up in value of goodwill, tangible and intangible assets[5] [$\sum^{2014}_{i=2008}$ *Sub tax*].

For instance, for 2015 the payment should be determined as follows:

$$Commission=\{[(DTAsc_{Dec312015}-DTAsc_{Dec312017})+DTAsc_{credit}-(\sum_{i=2008}^{2015}(IRES+additional)+\sum_{i=2013}^{2015}IRAP+\sum_{i=2008}^{2014}Sub\ tax)\}\times 1{,}5\%$$

Should the DTAs determined as described above exceed the amount of taxes paid, no payment is due.

The commission is to be paid within the deadline set for IRES and IRAP balance payments (i.e. for commission related to 2017, the payment must be performed by June 30, 2018).

[5] Reference is made to article 176(2-ter) of Italian Income Tax Code and to article 15(10), (10-bis) and (10-ter) of Law Decree 185/2008.

Chapter 5

Securities and derivative contracts

Dario Sencar | *Giovanni Falsitta*

Securities and derivative contracts represent a wide category of financial instruments that follow strict rules from an accounting and tax perspective. Indeed, as better explained below, many derogations to the reinforced derivation principle are applicable to the category[1].

In general, the most relevant international accounting principles dealing with securities and derivative contracts are IAS 32, IAS 39, IFRS 7 and IFRS 9. Guidelines can be found also in Circular 262/2005 issued by the Bank of Italy, which provides detailed rules for banks' financial statement drafting.

1. General accounting principles

The general rules governing the classification, presentation, and measurement of financial instruments in IAS/IFRS adopters' balance sheets, are contained in IAS 32 and IAS 39.

According to IAS 39, financial assets can be classified into: (i) Fair Value Through Profit and Loss ("FVTPL"), (ii) Held To Maturity ("HTM"), (iii) Loans & Receivables ("L&R"), (iv) Available For Sale ("AFS"). Financial liabilities shall be classified only into "FVTPL" and "other liabilities".

There are two "sub-categories" to the FVTPL class:

- Held For Trading ("HFT") which are financial assets or liabilities acquired principally for the purpose of selling or repurchasing in the near term and trading derivatives;
- Financial instruments designated on initial recognition as one to be measured at fair value with fair value changes in profit or loss (fair value option – "FVO").

HTM instruments are non-derivative financial assets with fixed or determinable payments and fixed maturity that an entity intends to hold to maturity.

L&R are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market other than:

- those that the entity intends to sell immediately or in the short term which shall be classified as HFT and those that the entity intends to classify as FVO;
- those that the entity classify as AFS;
- those for which the holder may not recover substantially all of its initial investment, other than because of credit deterioration, which shall be classified as AFS.

AFS instruments are defined as non-derivative financial assets that are not classified as L&R, HTM or FVTPL.

[1] We refer in particular to 85, 94, 101, 110, 112 and 113 ITC, to the detailed provisions of Ministerial decree 1/4/2009 and to the ones defined under Ministerial Decree 08/06/2011.

The AFS category includes all equity securities other than those classified as at fair value through profit or loss. An entity also has the right to designate any asset, other than a trading one, to this category upon its first recognition.

As far as the valuation criteria are concerned, under IAS 39 financial assets and liabilities must be recognized, initially, at their *fair value*[2]. However, subsequent variations in the values of financial instruments depend on their initial valuation method. In this regard, for FVTPL and AVS classified instruments, valuation should be computed according to fair value and for HTM and L&R subsequent variations, it should be computed at the amortized cost using the *effective interest method*[3]. Equity instruments that do not have a quoted market price in active markets and derivatives that are linked to and must be settled by such equity instrument, with unreliable fair value, should be valuated at cost.

In particular, with reference to FVTPL (i.e. HFT and FVO), subsequent changes in value should be booked as a variation in the profit and loss account.

Concerning AFS instruments, subsequent changes in value should be booked as a variation in the equity, however, if these instruments incur in permanent losses, the variation computed as equity reserves is offset and computed in the profit and loss account.

By the end of each FY, HTM and L&R instruments shall be subject to an impairment test in order to verify if there are losses that must be computed to the company's profit and loss account.

Under IAS 39, all derivatives are recorded at fair value in the P&L. This criterion would lead to a significant mismatch in the timing of P&L recognition if a hedging strategy is not in place and hedge accounting has not applied.

Hedge accounting indeed prevents the accounting mismatch through one of three ways:

- The risk being hedged in a fair value hedge is a change in the fair value of an asset or liability or an unrecognized firm commitment that is attributable to a particular risk and could affect P&L *(Fair Value Hedges)*.
  The carrying value of the hedged item is adjusted for fair value changes attributable to the risk being hedged, and those fair value changes are recognized in P&L. The hedging instrument is measured at fair value and fair value changes are also recognized in P&L.
- The risk being hedged in a cash flow hedge is the exposure to variability in cash flows that is attributable to a particular risk and could affect the P&L *(Cash Flows Hedges)*.
  Provided the hedge is effective, changes in the fair value of the hedging instrument are initially recognized in OCI. The ineffective portion of the change in the fair value of the hedging instrument (if any) exceeding the change in the hedged item (sometimes referred to as an "over-hedge") is recognized directly in P&L. For cash flow hedges of a forecast transaction which result in the recognition of a financial asset or liability, the accumulated gains and losses recorded in equity should be reclassified to P&L in the same period or periods during which the hedged expected future cash flows affect P&L. Where there is a cumulative loss on the hedging instrument and it is no longer expected that the loss will be recovered, it must be immediately recognized in P&L.

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[2] According to IAS 39, m.no. 9, "[f]air value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction".

[3] The carrying amount of financial instrument carried at amortized cost is calculated as the amount to be paid/repaid at maturity (usually the principal amount or par/face value), plus or minus any unamortized original premium or discount, net of any origination fees and transaction costs and less principal repayments. The amortization is calculated using the effective interest method. This method calculates the rate of interest that is necessary to discount the estimated stream of principal and interest cash flows (excluding any impact of credit losses) through the expected life of the financial instrument or, when appropriate, a shorter period to equal the amount at initial recognition. That rate is then applied to the carrying amount at each reporting date to determine the interest income (assets) or interest expense (liabilities) for the period. In this way, interest income or expense is recognized on a level yield to maturity basis.

- Exchange differences arising from the consolidation of net assets of a foreign operation are deferred in equity until the operation is disposed of or liquidated *(Hedges of net investment in a foreign operation)*. They are recognized in P&L, on disposal or liquidation, as part of the gain or loss on disposal. The foreign currency gains or losses on the hedging instrument are deferred in OCI, to the extent that the hedge is effective until the subsidiary is disposed of or liquidated when they become part of the gain or loss on disposal.

The IASB published the final version of IFRS 9 Financial Instruments in July 2014. The principle is effective for annual periods beginning on or after January 1, 2018. It was endorsed by EFRAG and published in the Official Journal of the European Union on November 29, 2016.

IFRS 9 provides for changes regarding the classification and measurement, impairment and hedge accounting.

For the purposes of this chapter, it is worth mentioning the new classification of the financial assets that removes the HTM, AFS and L&R categories in order to provide for three measurement categories:

- Amortized cost;
- Fair Value through Other Comprehensive Income (FVOCI);
- Residual category Fair Value through Profit or Loss (FVTPL);

The classification of the financial assets under one of these three categories has to be made in accordance to two tests:

- Business Model test, concerning how an entity manages its financial assets in order to generate cash flow by collecting contractual cash flows, selling financial assets or both. However, the determination is not dependent on the management's intentions for each individual instrument and should be made on a higher level of aggregation. As such, a business model is a matter of facts rather than an assertion. Objective information, such as business plans, how managers of the business are compensated and the amount and frequency of sales activity should be considered.
- Contractual Cash Flow Characteristics test, consisting in whether the contractual cash flows are solely payments of principal and interest (SPPI). Only financial assets with such cash flows are eligible for amortized cost or fair value through other comprehensive income measurements dependent on the business model in which the asset is held. For contractual cash flows to be SPPI they must include returns consistent with a basic lending arrangement, so for example, if the contractual cash flows include a return for equity price risk then that would not be consistent with SPPI.

The FVTOCI classification is mandatory for certain debt instrument assets unless the option to FVTPL is taken. Whilst for equity investments, the FVTOCI classification is an election.

For debt instruments measured at FVTOCI, interest income, foreign currency gains or losses and impairment gains or losses are recognized directly in P&L. The difference between cumulative fair value gains or losses and the cumulative amounts recognized in P&L is recognized in OCI until derecognition when the amounts in OCI are reclassified to profit or loss.

For equity instruments designated at FVTOCI, only dividend income is recognized in profit or loss with all other gains and losses recognized in OCI and there is no reclassification on derecognition.

Under the guidelines issued by the Bank of Italy for the drafting of financial statements of Italian banks, it is possible to identify the items which the financial instrument categories defined by IAS39 shall be allocated under.

In particular, limiting here the analysis to securities and derivative contracts, according to Circular 262/2005:

- HFT shall be allocated under item 20 (Assets) – *financial assets held for trading* or under item 40 (Liabilities) – *financial liabilities held for trading* and the related economic components under item 80 (P&L account) – *gains and losses on financial assets and liabilities held for trading*;
- FVTPL, other than HFT, shall be allocated under item 30 (Assets) – *financial assets at fair value through profit and loss* or under item 50 (Liabilities) – *financial liabilities at fair value through profit or loss* and the related economic components item 110 – *gains and losses on financial assets/liabilities at fair value through profit or loss"* is designated for investments valuated at their fair value comprehensive of FVO instruments;
- AFS shall be allocated under item 40 (Assets) – *available-for-sale financial assets* and the related economic components under item 100 b) – *gains (losses) on disposal and repurchase of available-for-sale financial assets"* and under item 130 b) – *net losses/recoveries on impairment available-for-sale financial assets"* are designated for AFS investments;
- HTM shall be allocated under item 50 (Assets) – *held to maturity investments* and the related economic components under item 100 c) – *gains (losses) on disposal and repurchase of held-to-maturity investments* and under item 130 c) – *net losses/recoveries on impairment held-to-maturity investments*;
- L&R shall be allocated under item 60 (Assets) – *loans and receivables with banks* or item 70 (Assets) – *loans and receivables with customers* and the related economic components under item 100 a) – *gains (losses) on disposal and repurchase of loans* and under item 130 a) – *net losses/recoveries on impairment loans*;
- Hedging derivatives shall be allocated under item 80 (Assets) – *hedging derivatives* and under item 60 (Liabilities) – *hedging derivatives* and the related economic components under item 90 (P&L account) – Fair value adjustments in hedge accounting comprehends fair value hedge derivatives valuations as well as the fair value of the financial instrument to the extent for the amount corresponding the hedged risk;
- Hedged items shall be allocated under item 90 (Assets) – *changes in fair value of portfolio hedged items* and under item 70 (Liabilities) – *changes in fair value of portfolio hedged items*.

In addition, P&L contains the following other items:

- Item 10 (P&L account) – *interest income and similar revenues* includes the positive spreads of hedging instruments;
- Item 20 (P&L account) – *interest expenses and similar charges* includes the negative spreads of hedging instruments;
- Item 70 (P&L account) – *dividend income and similar revenue* includes income deriving from investment in undertakings for collective investments (i.e. Investment funds);
- Item 100 d) - *gains (losses) on disposal and repurchase of other financial assets*;
- Item130 d) – *net losses/recoveries on impairment other financial assets"*.

2. Tax treatment

The tax treatment outlined below does not take into account the changes to be introduced by the IFRS 9.

To this end, Italian tax law[4] should be accordingly modified in order to adopt the new rules related, above all, to the elimination of the old categories and introduction of the new ones.

2.1. Securities

Italian tax law provides several and material derogations to the aforementioned reinforced derivation principle, so that the correct accounting of the financial instruments and their economic components are not sufficient to correctly determine the taxable income.

In particular, the ITC establishes the criteria to define current and fixed assets as well as the qualification and classification of the securities.

In relation to the distinction between current and fixed assets, the relevant provisions are found in article 85(3-bis) ITC which defines the fixed financial assets as the financial instruments other than those held for trading (i.e. securities accounted to the HFT portfolio and to the item 20 of Assets in the bank's balance sheet). In light of this, HFT is conversely considered current financial assets.

In relation to the qualification and classification, according to article 44 ITC the general principles are relevant regardless the *"nomen iuris"* or the accounting treatment of the securities, particularly considered that the IAS Decree explicitly derogates the reinforced derivation principle[5].

Italian tax legislation provides specific criteria by which a financial instrument (included commercial hybrids and hybrid capital securities) is to be defined as equity or debt.

In particular, the ITC distinguishes between securities that are to be considered "similar to shares" and those that are to be considered "similar to bonds" according to the following criteria:

- "Similar to shares": the relevant criterion is that the remuneration is entirely (*an* and *quantum*) made up by a participation to the economic results of the issuer, of other companies in the same group, or of a specific undertaking[6];
- "Similar to bonds": the relevant criterion is the unconditional obligation to pay, at maturity, a sum corresponding to not less than the nominal value, with or without the payment of a periodic remuneration. In addition, the security shall not entitle the holder with any direct or indirect management rights relating to the issuer or the deal relating to which the security was issued.

When a security can be qualified both as similar to shares and as similar to bonds according to the criteria above, the assimilation to the shares prevails and the main aspect to be considered is whether the remuneration fully derives from the economic results of the issuer[7].

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[4] In addition to the endorsement mechanism by EFRAG, Italian Civil and Tax Law provide for domestic adoption procedures. However if the competent Minister does not activate the procedure, no practical consequences will arise in terms of adoption. However, considering the material changes provided by IFRS 9, it is desirable that the procedure will be completed.

[5] See article 5 of the Decree of the Minister of Economy and Finance of 8 June 2011.

[7] See circular letter n.6/E/2006, paragraph 1.3.

This means that a misalignment arising from the accounting representation and the fiscal qualification is possible either when an equity instrument under IAS/IFRS does not meet ITC requirements and when a debt security has to be treated as equity instrument under the ITC. These could be the case of "interest-like" proceeds accounted in item 10 of P&L that has to be treated as dividends for tax purposes or, conversely, dividends allocated in item 70 of P&L that the ITC qualifies as interest or similar proceeds.

Based on the above, regardless of IAS/IFRS qualification and balance sheet classification, proceeds deriving from shares and securities similar to shares (distributed in every way and under every denomination) are treated for tax purposes as dividends[8].

Accordingly, dividend and other similar proceeds deriving from securities and other similar equity investments that meet the requirements above, are granted a dividend exemption (i.e. they are taxed up to 5% of their amount as provided by article 89 of the ITC on a cash basis).

However, this exclusion is not applicable to dividends deriving from i) participation allocated to the HFT portfolio, and ii) from entities resident in low tax jurisdictions unless it's possible to demonstrate the shifting of income to such low tax jurisdiction does not occur from the beginning of the holding period.

These rules apply also to the sums or the normal value of assets received by partners in the case of withdrawal, exclusion, redemption and reduction of excess capital or of liquidation, even in insolvency, of the companies and entities constituting profits for the part that exceeds the purchase price paid or the price of underwriting the cancelled stocks or shares.

In these cases, it should be taken into account that notwithstanding the decision of the Shareholders Meeting, profits distributed are assumed to be derived from the profit for the year and from the reserves other than those of the deferred taxes and those described in paragraph 5 (e.g. share premium reserve).

Other relevant issues to be considered in order to correctly determine the taxable income is that the ITC identifies the fiscal year during which dividends and other assimilated proceeds are to be taxed through a cash-basis criterion. Therefore, regardless the accrual-basis criterion defined by international accounting principles, dividends and other assimilated proceeds are subject to tax in the fiscal year during which they are actually paid.

Under this rule, when dividends are accounted for under IAS39 (generally, shareholders' meeting resolution) but not paid, they must be subtracted from taxable income. Conversely, when payment takes place, taxable income has to be increased for the dividends actually paid.

Otherwise, for interest and other assimilated income, to the extent that they are so considered also for tax purposes, the accounting rules have full relevance to determine the taxable income. Indeed, the ITC does not provide for total or partial exclusions and states the taxation on accrual-basis.

Accordingly, interest from securities based on forward swap contracts that mandate the forward resale of securities, contribute to the income of the transferee for the amount accrued during the term of the contract.

The positive or negative difference between the spot consideration and the forward consideration, net of interest accrued on the assets that are the object of the operation in the term of the contract, contributes to income for the share accrued in the period.

[8] Proceeds deriving from "silent partnership" where the shareholder contribution does not consist in performance of work or service have the same treatment.

Items of income consisting of fair value adjustments of securities, other than shares and similar financial instruments that are considered fixed assets, computed to the P&L on the basis of a correct application of international accounting standards, are also relevant for tax purposes[9].

However, the tax relevance of the fair value adjustments is subordinated to the allocation to P&L so that any valuation components recorded in equity remain irrelevant for tax purposes until these components are offset from equity and computed in the P&L.

This is specifically the case for financial instruments classified as AFS; the allocation of the fair value variations to the OCI does not gain tax relevance until the reversal in the P&L at the time of the security deletion or of the recognition of an impairment loss caused by a permanent value reduction.

On the contrary, regardless of the accounting category of allocation, valuation components related to fixed participation are always not relevant.

Briefly, it is possible to summarize that, for IAS/IFRS adopters:

- the mark-to-market valuation of equity instruments booked as HFT is relevant also for tax purposes;
- the mark-to-market valuation of other equity instruments (not booked as HFT) is not relevant for tax purposes;
- the mark-to-market valuation of other financial instruments is relevant for tax purposes.

Under Italian tax rules, disposal of financial assets could trigger sales revenue under article 85 of the ITC in the case of current assets or a capital gain/loss under respectively the article 86 and article 101 of the ITC in the case of fixed assets.

In the first case, banks should register simply the revenue from the asset sale, as the cost should be already allocated at the acquisition time as well as following any fair value adjustments.

In the second case, capital gains are subject to the rules of article 86 of the ITC and if certain requirements are met under article 87 of the ITC, they could benefit from the participation exemption regime consisting in a 95% taxation exemption.

According to article 86 of the ITC capital gains occurring upon the disposal of assets are determined as the difference between i) the sale price or the indemnity received, reduced by the costs directly attributable to the sale or the indemnity, and ii) the asset's value relevant for tax purposes.

In addition, in the case of financial assets not benefitting from the participation exemption regime outlined below allocated to fixed assets in the last three balance sheets, taxpayer can opt to defer taxation in a maximum of 5 yearly installments.

Capital losses are determined based on the IAS/IFRS criteria according to article 101 of the ITC. However, it is to be taken into account that in general losses could be allocated only if the assets are disposed or indemnified.

Under the participation exemption regime as disciplined by article 87 of the ITC, the 95% exemption of the realized gain is granted if the following requirements are met:

a) uninterrupted possession from the first day of the twelfth month preceding the month of the sale[10];
b) classification as financial fixed assets in the first financial statement of the possession period;

[9] This rule is not subject to the limitation on deduction of devaluations as defined under Article 94(4-bis) ITC, addressing non-IAS adopter.

[10] For this purpose, the LIFO principle applies.

c) tax residence of the subsidiary in a State or territory other than low-tax jurisdictions from the beginning of the possession period;
d) the subsidiary carried on a commercial enterprise for the 3 fiscal years preceding the year of the disposal of the shares (as defined in Article 55)[11].

Under a deeming provision (which no proof is allowed to reverse), the latter requirement is not met by holdings in companies whose assets consists mainly of immovable property. Buildings held under financial leases and land on which the held company performs an agricultural activity are considered directly used in the operation of the business.

For equity stakes in holding companies, the requirements of letters c) and d) refer to indirectly held companies and they apply to holdings that represent the majority of the value of the corporate net worth of the investor ("look-through approach").

If the conditions mentioned above are met, the capital gains are taxed up to the 5% and the capital losses shall not be deductible[12].

In addition, it is necessary also to consider that dividends received in relation to a holding meeting the participation exemption regime requirements sold before the accomplishment of the holding period are granted the dividend exemption but the fiscal value of the participation is decreased to the extent of the excluded dividend received.

Finally, it's worth mentioning that sales of securities from contango contracts and repurchase agreements that impose a forward sale of the securities on the buyer do not cause changes to inventories of the securities and therefore they do not determine the interruption of the period as for tax purposes the ownership is considered unchanged.

Particular cases occur when banks acquire shareholdings in order to recovery receivables from undertakings in crisis in occasion of financial restructuring operations.

In these cases, banks having the interest not to apply participation exemption regime have to demonstrate:

a) A higher convenience than other alternative recovery options together with the fact that the only operations carried out will be finalized to the net assets disposal; and
b) In the case of conversion of the receivables into participations, the temporary financial difficulty of the debtor, the reasonableness of the recovery plan and the acceptance of the recovery plan by the most part of the creditors.

This demonstration allows also to derogate the discipline providing for the tax irrelevance of the devaluations deriving from the impairment of fixed participations.

In essence, the effects of this treatment are:

- full deductibility of the fair value negative adjustments and of the capital losses deriving from the acquired/received participations;
- full taxability of the capital gains deriving from such participations up to the nominal value of the switched credits;
- 95% exemption for the capital gains deriving from such participations exceeding the nominal value of the switched credits;
- 95% exclusion for the dividends deriving from such participations.

[11] The active business test does not apply in the case of participated companies listed on a stock exchange.

[12] See article 101 TUIR "Capital losses on assets and non-operating losses".

2.2. Derivative Contracts

The distinction between trading and hedging derivatives operated by the banks according to IAS/IFRS is relevant in order to apply the correct tax discipline that in summary is applied to the following alternatives of hedging accounting:

- hedging derivatives designated for this purpose according to IAS 39;
- hedging derivatives for which the fair value valuation criterion is opted for;
- hedging derivatives designated to partially or specifically hedge cash flow or fair value variations above or below a threshold or based on other variables;
- hedging derivatives designated to hedge portfolio or group of assets/liabilities (i.e. macro hedge).

Trading derivative contracts' income components deriving from realization and measurement have full relevance for tax purposes; the reference is in particular to the elements allocated as gain and losses on HFT portfolio under item 80 of the bank P&L.

Conversely, hedging derivative contracts follow the tax discipline of the hedged asset/liabilities according to a symmetric principle of taxation. In light of this treatment, positive and negative components deriving from the valuation or the realization of the hedging activities incur in the same treatment of the hedged instrument's component provided that the hedge relationship is documented that was established prior to the negotiation of the derivative.

Therefore, in order to determine the right tax treatment to be applied to the valuation components of the hedging instruments, bank entities have to verify not only the hedging relationship between derivative and underlying instruments but also the tax treatment provided for fair value variations of the hedged instrument or cash-flow.

The main practical consequences deriving from the application of this approach can be exemplified by the following instances:

- valuation components of derivatives hedging fixed participations or other assets and liabilities whose valuation components are not tax relevant are not tax relevant;
- valuation components of derivatives hedging financial liabilities are not tax relevant as well as the valuation components of the hedged liability;
- valuation components of derivatives hedging fixed debt securities are tax relevant if allocated to P&L;
- valuation components of derivatives hedging loans to customers governed by the specific discipline stated in article 106(3) of the ITC are tax relevant.

Particular treatment has the cash-flow hedge derivatives whose valuation components are generally tax irrelevant; these instruments, indeed, have impacts on the taxable income only when the components registered in OCI are allocated to P&L[13].

Last, it is worth mentioning the tax relevance of the separate recognition of the embedded derivatives from the host instruments according to the IAS 39. This difference in respect of not-IAS adopters seems to be related to the reinforced derivation principle pursuant to which the separation of the two instruments reflects the prevalence of the IAS qualification, accrual-basis registration, and classification.

[13] This is the case of payment or receipt of the cash flows, the case of over-hedging or failure of the effectiveness of the hedging relationship and the case of other discontinuing situations where the hedge accounting finishes.

Chapter 6

ACE

Gabriella Forza | Giorgio Massa

ACE was repealed with the 2019 budget law. However, carry-forward of previous ACE surplus is preserved.

1. ACE: an abstract

Article 1 of Law Decree dated 6 December 2011 no. 201, converted by Law 22 December 2011 no. 214, has introduced, effective from the fiscal year including 31 December 2011, the so called "Allowance for Corporate Equity" (ACE) or Notional Interest Deduction (NID). The implementing Decree of the Minister of Economics and Finance dated 14 March 2011 and its explanatory report (so called "Implementing Decree"), have clarified the proper application of ACE.

The purpose of ACE is to equilibrate the tax treatment among equity-financed companies on one hand, and debt-financed companies on the other hand, rewarding those willing to reinforce their financial structure. Thus, the provision consists in a reduction of IRES taxation on equity financing through a deduction (only) for IRES purposes[1] corresponding to the notional return on equity ("ACE deduction").

In other word, ACE is a deduction from the Italian corporate income tax ("IRES") tax basis (after using any available tax losses) that corresponds to the net increase in the equity employed in the entity, occurred after the financial year as at 31 December 2010 (the "Eligible Equity"), multiplied by a rate determined by Law[2]. This rate was set at 4.5% for FY 2015, 4.75% for FY 2016, 2.3% for FY 2017 and 2.7% from FY 2018. In case the ACE deduction is higher than the net business income, the excess can be carried-forward to increase the ACE deduction in the subsequent fiscal years with no time limit. This means that a company (including permanent establishment of foreign companies) cannot declare a tax loss due to the ACE deduction and, in case of a tax loss, ACE cannot increase the tax loss.

Article 2 of the Implementing Decree has clarified that ACE is applicable to companies and entities resident in Italy according to article 73(1)(a) and (b) of the Italian Tax Code ("TUIR"), and is also applicable to permanent establishment of nonresident companies and entities according to letter (d) of the aforementioned article 73(1). Consequently, the ACE deduction is also available to Italian branches of UE and extra UE banks (hereinafter also "PE").

As to the first year of application of ACE Deduction, relevant elements to be considered as Eligible Equity (also for PE – but with some differences – as following described) are:

1) net equity resulting from the 2010 balance sheet, without considering profits accrued (profits accrued in 2010 represent an increase relevant for ACE purposes);
2 equity increases, consisting in, e.g.: (i) shareholders' cash contributions (including losses coverage), (ii) contributions to acquire shareholder capacity, (iii) profits appropriated to reserves, except for those appropriated to unavailable reserves;

1 The ACE deduction is not relevant for Italian Regional Income Tax ("IRAP") purposes, since it is a non-accounting deduction and therefore not included in IRAP tax basis.

2 The explanatory report specifies that if the fiscal year is longer or shorter than a calendar year, the amount of "new equity" is proportional to the effective length of the period in order to make the deduction homogeneous with the year basis notional return rate.

3) equity decreases, consisting in decreases of net equity due to shareholders' attributions for any title. Consistently, decreases in net equity due to accounting losses do not reduce the ACE basis;
4) equity reduction due to anti-avoidance provisions, which include: (i) consideration for acquisition or participation increases in controlled companies, (ii) consideration for acquisition of business concerns (of branches thereof) already belonging to the group, (iii) cash contributions made by non-resident companies (controlled by resident companies) or made by "black-list" entities, (iv) cash contributions in favour of controlled companies or between companies controlled by the same subject (even if the control is no longer in place), (v) increase in financing credits by companies belonging to the same group, in comparison with their value in the 2010 balance sheet.

However, article 11 of the Implementing Decree provides that the ACE basis cannot exceed the amount of the net equity in each fiscal year[3] (so called "net equity limit"). This means that if net equity is negative or zero, no ACE deduction is granted[4]. A simple example can describe the impact of the "net equity limit".

Example n. 1.

Equity 31.12.2015		
Share Capital	100.000,00	
Reserves	50.000,0	
Profit(loss) of period	40.000,0	
Total equity	**110.000,0**	
Ace Basis (previous fiscal years)	170.000,00	B
Ace Basis (FY15)	110.000,00	C=A

Suppose that the accounting loss of fiscal year 2015 is equal to € 40.000,00 and that the amount of ACE basis of previous fiscal year (2014) was € 170.000.00. As a consequence of the net equity limit rule, ACE basis cannot exceed the net equity of the period, thus, in the example, must be capped at € 110.000,00 (with a basis reduction of € 40.000,00).

However, considering that net equity limit must be verified in each fiscal year, the negative effect showed in the example could be only "temporary" (e.g. replaced by the net profit of the subsequent period; by shareholders' cash contributions etc.).

Moreover, the net equity limit has to be considered only after the sum of increases and decreases in net equity have been reduced by any sterilization due to ACE anti-avoidance rules (point 4) above). These provisions are aimed to avoid the ACE deduction basis to be multiplied (i.e. the abusive purpose) through capital injections among companies belonging to the same group, under the assumption that the management and the plurality of entities within a group encourage capitalizations for convenience. In other words, the Implementing Decree introduced some rules in order to monitor cash contributions and acquisitions among companies belonging to the same group. In fact, cash contributions and acquisitions from third parties can instead be challenged on the basis of the general anti-avoidance rule (e.g. art. 10-bis, Law no. 212, 2000).

[3] Determined excluding the reserves for the purchase of own shares and including the profit/loss of the period (to be determined without considering the fiscal effects of ACE).

[4] This means that negative impact could be observed, among other, for companies with relevant accounting losses carried forward.

2. ACE and permanent establishment

As mentioned above, the ACE mechanism finds application also to permanent establishments, but with some differences than the general provision: as highlighted by Italian Tax Authority ("ITA"), the application of ACE deduction to permanent establishment is necessary to guarantee the principle of non-discrimination[5].

In particular, with reference to permanent establishments of foreign banks, article 2(2) of the Implementing Decree clarifies that capital increases occurred in fiscal year 2011 are relevant for ACE deduction purposes. The Explanatory report has specified that *"with reference to permanent establishments of foreign companies, the branch capital and its increases have to be, in any case, those resulting from the tax return of the fiscal year which have to be proper, form a tax point of view, according to international shared principles. Indeed, as any independent company, the permanent establishment of a non resident company is obliged to own a branch capital which, for tax purposes, can also be "figurative" and therefore has to be in any case determined, regardless its book value. In addition, it is also highlighted that, with reference to permanent establishments, any reference to shareholders is to be intended as referred to the head office"*.

On the basis of a strict interpretation of the above provision, the relevant data for ACE purposes are the branch capital and its relative increases which are proper, for tax purposes, according to international principles (i.e. OECD principles), regardless of its book value. In the past this statement led to doubts in the interpretation of the provision, making the application of the ACE rules to permanent establishment very uncertain.

On the light of the above, The ITA has given some clarification in relation to the ACE calculation for PEs by issuing Circular Letter No. 21/E 2015. In particular, the ITA specified that for PE the initial data to be used to determine relevant ACE increases is the greater value between the book value of the free capital as of December 31, 2010 (net of profit of the period) and the proper (considering OECD principles) free capital for tax purposes at the same date (hereinafter also "figurative free capital").

For this purposes, it has to be noted that:

- the book value of the free capital is the capital resulting from the PE balance sheet as of December 31, 2010;
- the effective free capital is the capital resulting from the PE balance sheet after the pro rata temporis effect related to capital increases and decreases;
- the figurative free capital is the proper branch capital relevant for tax purposes, according to OECD principles. In particular, according to the ITA, determining the branch capital for tax purposes is necessary to quantify the amount of deductible interest expenses arising from funding received by the permanent establishment from its Head Office.

The above said, the book value of the free capital and the figurative free capital could not coincide, considering the different treatment of various elements, such as contribution in cash made the Head Office in favor of the PE (as explained in the ITA's Circular Letter No. 21/E 2015).

[5] From a legal point of view, the permanent establishment of a foreign bank is not considered an independent and separated entity from its Head Office (as it represents a mere administrative branch), while from a fiscal point of view it is considered a separate entity.

In particular, Circular Letter No. 21/E 2015 analyses the following example: "if the book value of the free capital on December 31, 2010, would be equal to 100 and composed of a sole contribution in cash from the Head Office made on October 1, 2010, the free capital relevant for the adequacy test (e.g. effective free capital) on December 31, 2010, would be equal to 25, considering that the adequacy condition has to be constantly respected for the whole fiscal year. This effective free capital should be subject to a fiscal adequacy test, on the basis of principles acknowledged internationally".

In light of the above, the ITA clarified that if the effective free capital on December 31, 2010, would not be fiscal adequate, the taxpayer would have to: (a) operate an accounting adjustment or (b) operate a fiscal adjustment.

The Report of the Implementing Decree specifies that the relevant ACE adjustments could be determined considering directly the increases or decreases, without any reference to 2010. This could be applicable to the Italian branches of UE and extra UE banks only if the 2010 free capital would result as fiscally adequate; otherwise, it would not be possible.

After the clarification on ACE calculations for PEs, the ITA analysed the relevant ACE adjustments. Circular Letter No. 21/E 2015 deals with the adoption of an identification criterion for the adjustments of single increase/decrease annual flows. In particular, the increase adjustments are: (i) cash contribution from the Head Quarter to the PE; (ii) PE profits; (iii) accounting adjustments and/or fiscal adjustments. The decrease adjustments are represented by the reduction of the PE book value of free capital in favour of the Head Quarter. The ITA also clarifies that the total amount of adjustments could not exceed the greater between the book value of the free capital and the fiscal adequate free capital.

After the analysis of the adjustments, the ITA examines in detail accounting and fiscal adjustments. In particular, a PE could consider fiscal adjustments among the increases (e.g. increase adjustments inserted in the tax return in order to obtain a fiscal adequate free capital). However, these adjustments are subject to two limits: (a) fiscal adjustments are temporary amendments, so they are effective exclusively for the relative fiscal year; (b) fiscal adjustments are usable in the limit of the figurative free capital.

These limitations are directed to avoid adjustments set for the specific aim of obtaining a pure fiscal advantage.

The ITA deals also with increase adjustments for accounting purposes. According to the ITA, these adjustments are permanent and should be treated as other cash contributions.

Last, the ITA explained that the relevant time for the increase under analysis is the date of the effective contribution (e.g. pro rata temporis criterion).

A simple example can describe the application of ACE on the light of the ITA approach.

Example n. 2.

	2010	2011	2012	2013	2014	
Adequate fiscal free capital	350,000,000	310,000,000	370,000,000	390,000,000	410,000,000	A
Effective free capital (relevant for fiscal adequate test)	205,000,000	265,000,000	295,000,000	325,000,000	360,000,000	B
Accounting free capital for ACE	180,000,000	230,000,000	260,000,000	305,000,000	345,000,000	C
Equity deficit (difference between accounting and adequate free capital 2010)	(170,000,000)	(170,000,000)	(170,000,000)	(170,000,000)	(170,000,000)	D
Fiscal Deficit	(145,000,000)	(45,000,000)	(75,000,000)	(65,000,000)	(50,000,000)	
Interest	2.0000%	2.0000%	2.0000%	2.0000%	1.5000%	
Fiscal Adj.	2,900,000	900,000	1,500,000	1,300,000	750,000	
Reserves	30,000,000	80,000,000	110,000,000	155,000,000	195,000,000	
Loss						
Capital	150,000,000	150,000,000	150,000,000	150,000,000	150,000,000	
Profit (Loss)	50,000,000	70,000,000	70,000,000	40,000,000	30,000,000	
Downgrade/ Contribution (ip. on 1/1)			(40,000,000)	(25,000,000)		

ACE Increases Calculation					
Total accounting fiscal adj.					
PE Income	50,000,000	120,000,000	150,000,000	165,000,000	
Cash contribution/accounting free capital reduction	-	(40,000,000)	(25,000,000)	-	
Accounting adj.	-	-	-	-	
Fiscal adj.	45,000,000	75,000,000	65,000,000	50,000,000	
Total increase/decrease	**95,000,000**	**155,000,000**	**190,000,000**	**215,000,000**	
Increase/decrease 2010	**(75,000,000)**	**(15,000,000)**	**20,000,000**	**45,000,000**	
ACE base	**-**	**-**	**20,000,000**	**45,000,000**	
Yield	**3.00%**	**3.00%**	**3.00%**	**4.00%**	
ACE	**-**	**-**	**600,000**	**1,800,000**	**2,400,000**

The example above simulates the accounting and fiscal condition of an Italian PE during FY 2010-2014. The example presents the following criteria:

- Adequate fiscal free capital (A);
- Effective free capital, used as parameter for the adequate test, which can be different from accounting free capital (B);
- Accounting free capital for ACE, e.g. data resulting from the annual statement, net of FY income (C).

By using these data it is possible to calculate the equity deficit (D), e.g. the difference between accounting free capital for ACE on December 31, 2010 and adequate free capital at the same date (A). In particular, this difference is equal to € 170,000,000.

Moreover, for each FY the fiscal deficit is to be calculated, i.e. the difference between the adequate fiscal free capital (A) and the effective free capital (B), equal to € 145,000,000 for FY 2010; € 45,000,000 for FY 2011; € 75,000,000 for FY 2012; € 65,000,000 for FY 2013; € 50,000,000 for FY 2014.

In light of the above, it is necessary to analyze how the increases and decreases registered determine (or not) relevant adjustments for ACE increases. In FY 2011, no relevant adjustment is registered, because the total amount of increases, equal to € 95,000,000, is not sufficient to assimilate the equity deficit equal to € 170,000,000 (C). The same situation is verified in FY 2012. On the other hand, in FY 2013, the total amount of increases is equal to € 190,000,000, this amount comes from the sum of the PE income (€ 150,000,000), the downgrade from the HQ (€ -25,000,000) and the fiscal adjustment (€ 65,000,000), and it is bigger than the equity deficit equal to € 170,000,000 (C). The difference equal to € 20,000,000 is the ACE Base on which is calculate the rate relative to the notional return expected for FY 2013, e.g. 3%. The relevant adjustment for ACE is equal to € 600,000. The same situation is verified for FY 2014, the total amount of increases is equal to 215,000,000 €, this amount comes from the sum of the PE income (€ 165,000,000) and the fiscal adjustment (€ 50,000,000), and it is bigger than the equity deficit equal to € 170,000,000 (C). The difference, equal to € 45,000,000, is the ACE base for calculating the rate relative to the notional return expected for FY 2013, e.g. 4%. The relevant adjustment for ACE is equal to € 1,800,000. At last, the ACE increases for the PE for FY 2010-2014 is equal to € 2,400,000.

Chapter 7

Italian regional tax - IRAP

Alessandro Catona | Rocco Mottolese

1. General features

Italian resident companies and permanent establishments of non-resident companies in Italy are subject to the regional tax on productive activities, i.e. "IRAP".

IRAP was established under Italian Legislative Decree no. 446/1997 (so called IRAP Decree) and it affects companies exercising productive activities. IRAP is levied on the net value of production *(valore della produzione netta)* deriving from activities performed locally in each of the 20 Italian regions, and the way the tax base is computed changes depending on the type of taxpayer and on the type of activities carried out.

For banking entities, IRAP is generally levied at a basic 4.65% rate on the gross margin attributable to the activities carried out in Italy. Tax is levied on a regional basis and each region is permitted to increase or decrease the tax rate up to 0.92%; for this reason the general rate applicable to banks is 5.57%. Branches with facilities in different regions must allocate the overall taxable basis to the different regions on the basis of the amount of client cash deposits and securities held at bank offices of each region.

The rules of determination of IRAP's taxable base have been completely modified by the Financial Law 2008 (Legislative Decree no. 244/2007). The most important innovation was related to the so-called "disconnection" of IRAP from the Italian corporate income tax (i.e. "IRES") after the abrogation of art. 11-bis of the IRAP Decree which provided that the rules relevant for the determination of the tax base for IRES purposes were also applicable for IRAP purposes. Thus, starting from 2008, IRAP has become independent from IRES, meaning that all the positive and negative adjustments required by the Corporate Income Tax Law no longer apply for IRAP purposes: on this basis, the determination of the regional tax due has been significantly simplified.

As far as banks are concerned, art. 6 of the IRAP Decree establishes the rules of determination of the net value of production. In particular, the tax base is determined as a sum of the following profit and loss account's items:

- intermediation margin reduced by 50% of dividends;
- depreciation and amortization of functional tangible and intangible assets, for an amount of 90%;
- other administrative expenses, for an amount of 90%;
- 100% of receivables write-downs net of revaluations concerning receivables from customers duly booked in P/L.

Moreover, unlike for IRES purposes, no tax losses can be carried forward.

The same art. 6 of the IRAP Decree specifies that *"positive and negative adjustments are considered valid if booked in the Profit and Loss Statement prepared according to*

the Provision of the Bank of Italy issued on December 22, 2005[1] *and February 14, 2006, implemented in accordance with the art. 9 of the Legislative Decree no. 38 of February 28, 2005 and published accordingly in the ordinary additions to the Official Journal no. 11 as of January 14, 2006 and no. 58 as of March 10, 2006".*

It should be noted that according to the amendments provided by the Legislative Decree no. 147/2015, the so-called "Internationalization Decree", starting from fiscal year 2016, Italian permanent establishments are required to prepare the income statement and the balance sheet following the accounting principles that would have been adopted by Italian resident entities carrying out a similar business. Consequently, for the correct determination of IRES and IRAP in Italy, permanent establishments carrying out banking activities shall adopt IAS standards and prepare financial statements as provided by the Provision of the Bank of Italy.

2. The rule of "direct derivation"

The combined effect of art. 9, Legislative Decree no. 38/2005, cited in the art. 6 of the IRAP Decree and the abrogation of art. 11-bis of the IRAP Decree, implied the introduction of the so-called rule of "direct derivation". According to this principle, profit and loss statements of the banks (who are IAS adopters) – prepared according to the instructions of the Bank of Italy – represent the starting point for the calculation of the tax base for IRAP purposes while any adjustments made for IRES purposes is irrelevant.

The rationale of this amendment was to *"simplify the rules for determination of the tax base for IRAP purposes"*, considering:

- as much as possible the values deriving from the income statement, on the one hand; and
- on the other hand, the Legislator wished to separate *"the functional and declarative discipline from the discipline concerning corporate income taxes"*.

These principles are reaffirmed in the explanatory report to the same Financial Law 2008, which clearly states that the main purpose is to disconnect the regional tax from the corporate income tax. The report confirms that *"the new IRAP, in fact, should be the first example of direct tax whose tax base will derive entirely from the financial statements"*.

As a consequence of the rule of "direct derivation", the concept of relevant costs for IRAP purposes is different from the concept of relevant costs that was previously used for general tax purposes and still continues to be applicable for IRES (the so-called *"principio di inerenza"*). Indeed, for IRAP purposes all the revenues and expenses become relevant when they are classified in the items of financial statements which make part of the IRAP taxable base as indicated by the IRAP Decree.

The Italian Tax Authorities have clarified in the Circular of July 10, 2009, no. 33/E, par. 2, that the principle of "direct derivation", introduced by the Financial law 2008:

- applies to transactions executed starting from the tax period following the one in progress on December 31, 2007 (i.e. 2008);
- does not apply to transactions carried out in the previous tax periods which meet the requirements for the application of the transitional regime;
- applies to transactions carried out in the previous tax periods which do not meet the requirements for the application of the transitional regime.

[1] These rules were updated on December 15, 2015.

It is worth mentioning that there is an exception to the "direct derivation". Such exception refers to extraordinary transactions not relevant for tax purposes. In particular, in case of merger, split-up or transfer of the company, the major (o minor) values resulting from the financial statements of the beneficiary company are not recognized for tax purposes unless the company opts for the payment of substitute tax.

3. Correlation rule

Another important principle to consider in order to determine the IRAP tax base is the correlation rule. In particular, the Decree specifies that *"the positive and negative components booked in the profit and loss statement items different from those indicated in the par. 1, make part of the taxable base if related to the components included in the tax base in the previous or future tax periods"*.

This rule aims to give relevance for the determination of IRAP tax base to all components classified, according to Bank of Italy's provisions, in profit and loss items correlated to the ordinary components booked in the items specifically indicated by art. 6 (such components are not explicitly included in IRAP tax base).

Furthermore, the Italian Tax Authority, with the Circular no. 27/E of 2009, extended the application of the correlation rule. On this base, income deriving from infra-group services should be relevant for IRAP purposes if the relative infra-group costs make part of the IRAP taxable base (for example, in case of administrative expenses, 90% of the correlated income will become relevant).

It should be taken into account that there still is a confusing issue, which has never been clarified by the Italian Tax Authorities regarding the definition of correlation. Indeed, it is possible to identify two main types of correlation:

i. direct correlation – characterized by tight connection between two components of the tax base (e.g., recharges of the costs anticipated by the bank towards a client);
ii. indirect correlation – characterized by a connection based on a specific activity to which such components are related to (e.g., if we consider the activity of rented property management, the leasehold improvements booked in an item not relevant for IRAP purposes will become relevant if related to income produced by such properties).

This being said, as far as direct correlation is concerned, there should be no doubt that such components are to be considered relevant for IRAP purposes. On the other hand, it seems quite doubtful whether it should be possible to include in the IRAP tax base also components not directly correlated to the relevant revenues/expenses. At this point, further interpretation of Italian Tax Authorities is necessary.

3.1. Some particular rules

Based on the rules described above, generally all components included in the intermediation margin should be relevant for IRAP purposes while components below the margin and different from specific items indicated in art. 6 of the IRAP decree should not be included in the tax base. In this regard, it could be useful to outline some items that are characterized by a specific treatment.

3.2. The components recognized directly in equity or in OCI

The relevance of the items recognized directly in equity or in OCI prospectus for the determination of the IRAP tax base is much debatable. The Italian Tax Authorities, in Circular no. 27/E of 26 May 2009, has clarified that *"substantially, the tax base for IRAP purposes is represented by the algebraic sum of specific items of the income statement of banks (as provided by the Circular no. 262 of December 22nd, 2005) which are expressly indicated in Art. 6 of the IRAP Decree, considering the adjustments and integrations provided for and excluding the amounts recognized directly in equity"*.

This paragraph reaffirms the rule of "direct derivation" from financial statements for the calculation of IRAP tax base, according to which IRAP taxable base is determined as a sum of specific items of profit and loss statement, excluding the components booked in the different items of financial statements as, for example, are the components recorded directly in equity or in OCI.

Though the aforementioned circular seemed to clarify the issue, the lack of a specific rule was tackled by the Legislator with the Decree of 8 June 2011. Art. 2(2) of the latter decree provided that *"the components relevant for IRAP purposes, recorded directly in equity … contribute to the formation of the IRAP tax base at the moment when they are booked in the income statement. If such components are never booked in the income statement, their tax relevance should be established according to the provisions of IRAP Decree, independently from their imputation to equity"*.

This provision has filled in the previous legislative gap, giving explicitly relevance to the components recorded in equity for IRAP purposes.

However, the Legislator has not fully clarified the mechanism of application of the provision for those components that will never be booked in the income statement. Neither has the financial administration expressed official guidance on this point.

In this regard, there could be two possible interpretations of the sentence *"according to the provisions of the IRAP Decree"*:

i. according to the first, the sentence would imply that the components, recorded in equity and which will never be booked in the income statement, should be considered for IRAP purposes based on the income statement item where they would have been classified if they had been booked in the income statements (consistent also with the provisions in force prior to the Financial Law 2008);
ii. according to the other interpretation, the sentence should be strictly interpreted and the items to be considered would only be those indicated in art. 6 of the IRAP Decree, as far as banks are concerned. Thus, the components recorded in equity, which will never be booked in the income statements, should not become relevant for IRAP purposes.

The latter interpretation should be consistent with the Circular no. 27/E/2009 and would imply the general irrelevance of these components, which, consequently, could become relevant for IRAP purposes only based on the correlation principle, or through a specific provision of law.

The Italian tax authorities have confirmed this theory in some tax rulings not rendered public. At this point, an official confirmation should be necessary in order to definitively clarify the issue.

3.3. Dividends (Item 70 of the Income Statement)

Pursuant to the Circular of the Bank of Italy no. 262 of 22 December 2005, dividends and similar income should be booked in the item 70 of the income statement. This item also includes income deriving from OICR and does not include dividends booked in the item 280 "Profit (loss) on assets held for sale net of tax" or booked directly to the Participation (equity method).

In this regard, art. 6(1)(a) of the IRAP Decree provides that dividends are relevant for IRAP purposes only at 50% of the amount booked in financial statements.

It is worth mentioning that the article refers only to a part of item 70 "Dividend and similar income" as booked in the income statement of the bank.

As specified by the Italian Tax Authorities in the Circular of 26 May 2009, no. 27/E, dividends booked under item 280 "Profit (loss) on assets held for sale net of tax" are not relevant for IRAP purposes (it is reasonable to suppose that the same principle is applicable to dividends booked directly to the participation).

Moreover, in the same Circular the Italian Tax Authorities also clarified that 50% of dividends is to be interpreted in the strict sense, meaning that the income deriving from collective investment funds should not be considered and, thus, will be taxed at 100% for IRAP purposes.

3.4. Gains (losses) from sale or repurchase of loans, financial assets, financial liabilities (Item 100 of the Income Statement)

Item 100 of the income statement "gains/losses on disposal", concerning gains and losses realized on sale of financial assets classified as loans and receivables (L&R), as financial assets available for sale (AFS) and as financial assets held to maturity (HTM), as well as gains and losses realized from repurchase of its financial liabilities, included in intermediation margin, is directly relevant for IRAP purposes.

Conversely, on the basis of the combined examination of circulars issued by the Italian Tax Authorities (no. 12 of February 12, 2008, no. 27/E of May 26, 2009, no. 36/E of July 16, 2009 and no.14/E of June 4, 2014), item 130 that includes the write-downs and revaluations relative to loans granted to clients and to banks (item 130a), to financial assets available for sale (item 130b) and to financial assets held to maturity (item 130c) is relevant for IRAP purposes due to the correlation rule.

More in detail, in accordance with the above-mentioned circulars, adjustments posted under item 130 of the income statement until the fiscal year 2007, even if realized through sale in a subsequent year, should not be relevant for IRAP purposes. On the contrary, write-downs and revaluations posted under item 130 of the income statement starting from 2008 should become relevant for IRAP purposes in the fiscal year when they are realized through sale.

An example could better explain what we have summarized above:

- suppose there is a HTM asset purchased at 1.000 in March 2007;
- at 31 December 2007, the asset is written-down by 300; after the adjustment, its book value becomes equal to 700, which will be also its value for IRAP purposes for all operations that will affect that asset starting from January 1, 2008;

- in 2009 the asset is further written-down by 150, its book value becomes equal to 550, while for IRAP purposes the value remains equal to 700;
- in 2010 the asset is sold at 600.

From an accounting point of view, the gain in the item 100 of the income statement is equal to 50 but the transaction realized an overall loss of 400. For IRAP purposes the loss amounts to 100. To recognize the IRAP loss a branch needs to deduct the write-down booked during fiscal year 2009 while the first adjustment made in fiscal year 2007 is not relevant for IRAP purposes.

Fiscal year	Description	Book Value	IRAP Value
2007	Purchase price	1.000	
2007	Write-down in P&L	-300	
31 Dec 2007	*Residual value*	700	700
2009	Write-down in P&L	-150	-
31 Dec 2009	*Residual value*	550	700
2010	Sell price	600	600
2010	Income in P&L	50	50
2010	***Overall result***	***-400***	
2010	***Loss for IRAP purposes***		***-100***

As far as the write-downs of loans are concerned, following the amendments provided by the Regulators (according to which such write-downs were deductible in five years for fiscal years 2013 and 2014 and entirely from fiscal year 2015), the correlation rule works only for the adjustments posted from 2008 to 2012 (included).

Moreover, Italian Tax Authorities clarified that the above-mentioned principle still applies to adjustments recorded directly in equity (or OCI) according to IAS principles: they are not relevant for IRAP purposes in the year when such adjustments are booked, while they become relevant at the moment of sale or disposal of the asset.

3.5. Provisions for risks and charges (Item 160 of the Income Statement)

With regard to the treatment of provisions for risks and charges for IRAP purposes, it should be noted that, generally, such provisions are booked under an item not included in the intermediation margin (item 160) and, thus, should be not relevant.

However, as far as the utilization of such provisions is concerned, the Italian Tax Authorities (with their Circular no. 12/E of 19 February 2008, so-called Telefisco 2008) have clarified that, if in the absence of provisions accrued in the previous years, the expenses borne should have been recorded under an item relevant for IRAP purposes, such provisions could potentially become relevant for the computation of the IRAP tax base.

In other words, expenses covered by provisions for risks and charges not deducted for IRAP purposes, should become deductible:

- in the fiscal year when such expenses are actually incurred;
- only if their classification was relevant for IRAP purposes.

3.6. Deductibility of the labour cost for IRAP purposes

Deduction for labour costs have been historically limited for IRAP purposes. However, the 2015 Stability Law introduced the deductibility of labour costs relating to employees working under an open-ended contract, effective from the fiscal year following the fiscal year in progress as of 31 December 2014. Considering that other labour related costs, such as mandatory insurance expenses against work-related accidents, were already deductible, currently most labour costs are deductible for IRAP purposes.

Prior to the 2015 budget law, i.e. up to the fiscal year in progress at December 31, 2014, labour costs were not deductible for IRAP, however, it was possible to deduct an amount equal to € 7,500 on an annual basis for every employee working under an open-ended contract, increased to € 13,500 for women and employees under 35 years old.

Such deductions were increased respectively to € 15,000 and € 21,000 for employees working in certain regions, i.e. Abruzzo, Basilicata, Calabria, Campania, Molise, Puglia, Sardinia and Sicily.

Moreover, companies were allowed to deduct, from their total amount, the social security and welfare contributions related to employees with open-ended contracts.

Costs relating to employees involved in research and development activities (proportionally to the amount of time effectively involved in such activity) are deductible for IRAP purposes. However, the law does not permit the combination of these different tax benefits.

As previously mentioned, starting from fiscal year 2015, labour costs related to open-ended contracts are deductible for IRAP. The Stability Law 2015 introduced the following IRAP amendments:

- the full deductibility from the IRAP tax base of the labour cost relating to long term employees starting from the fiscal year following the one in progress at December 31, 2014;
- the possibility, for taxpayers without long term employees, to benefit from a tax credit equal to 10% of the IRAP paid starting from the fiscal year following the one in progress at December 31, 2104.

3.7. Conversion of ACE deduction into IRAP tax credit

As described in the relevant chapter, ACE is a mechanism that allows to deduct a notional return on equity from taxable income for IRES purposes. Art. 19, Decree Law no. 91/2014 has introduced, since the fiscal year ended on 31 December 2014, the possibility to convert ACE not used for IRES purposes into IRAP tax credit. The tax credit is calculated by applying the IRES tax rate (27.5% until fiscal year 2016, 24% for further fiscal years) to the surplus of ACE, and can be used to offset IRAP payments in equal amounts over the following five years.

Starting from fiscal year 2014, following this rule, an entity has two different alternatives to use the surplus of ACE:

i. carrying forward the ACE excess;
ii. converting the ACE excess into IRAP tax credit.

In accordance with the Italian Tax Authority (Circular Letter No. 21/E of 2015) the possibility to realize the above-mentioned conversion is not applicable to the ACE surplus accrued in fiscal years previous to 2014.

Moreover, the Italian Tax Authority has clarified that the IRAP tax credit arisen from the ACE excess transformation:

- can be used only for IRAP purposes and not to offset other tax debts;
- cannot be transferred and cannot be claimed as a refund;
- cannot be transferred within a group taxation.

Contributors

Matteo Calizzi holds an LL.M. in International Tax Law from King's College London; he currently serves as a senior associate with PwC TLS Avvocati e Commercialisti, in Milan.

Alessandro Caridi is a Dottore Commercialista and holds an LL.M. in International Tax Law from Leiden University; he currently serves as a partner with PwC TLS Avvocati e Commercialisti, in Milan.

Alessandro Catona is a Dottore Commercialista; he currently serves as a partner with PwC TLS Avvocati e Commercialisti, in Milan.

Rubina Fagioli is a lawyer and holds an LL.M. in Taxation from the School of Law of Queen Mary University of London; she currently serves as a manager with PwC TLS Avvocati e Commercialisti, in Rome.

Giovanni Falsitta is a Dottore Commercialista; he currently serves as a senior manager with PwC TLS Avvocati e Commercialisti, in Milan.

Gabriella Forza is a Dottore Commercialista; she currently serves as a senior manager with PwC TLS Avvocati e Commercialisti, in Milan.

Marianna Franchini is a Dottore Commercialista; she currently serves as a senior associate with PwC TLS Avvocati e Commercialisti, in Milan.

Edgardo Gagliardi is a lawyer; he currently serves as a director with PwC TLS Avvocati e Commercialisti, in Milan.

Michele Gusmeroli is a Dottore Commercialista and holds an LL.M. in International Tax Law from Leiden University; he currently serves as a director with PwC TLS Avvocati e Commercialisti, in Milan.

Caterina Innamorato is a Dottore Commercialista and holds an LL.M. in International Tax Law from Leiden University; she currently serves as a director with PwC TLS Avvocati e Commercialisti, in Milan.

Giorgio Massa is a lawyer; he currently serves as a director with PwC TLS Avvocati e Commercialisti, in Milan.

Rocco Mottolese is a Dottore Commercialista; he currently serves as a director with PwC TLS Avvocati e Commercialisti, in Milan.

Carlo Romano is a lawyer (qualified to lodge cases before the Italian Supreme Court), holding an LL.M. from LUISS University of Rome and a PhD from the University of Groningen; he currently serves as a partner with PwC TLS Avvocati e Commercialisti, in Rome.

Dario Sencar served for many years with the Italian Tax Authority, taking part in several working groups within the BEPS project; he currently serves as a partner with PwC TLS Avvocati e Commercialisti, in Milan.

Federico Traversa is a Dottore Commercialista; he currently serves as a manager with PwC TLS Avvocati e Commercialisti, in Milan.

Marco Vozzi is a Dottore Commercialista; he currently serves as a partner with PwC TLS Avvocati e Commercialisti, in Milan.

Both the contributors and the editors have worked with the maximum possible accuracy. Mistakes and omissions, however, can still take place: especially when dealing with a subject matter as complex and structured as tax law. Italian tax law, in particular, is ever changing and no account was taken of amendments coming into force after the reference date.

As a result, no decision should be taken on the sole basis of this book, without first having sought specialized tax advice confirming the correctness of the intended approach.

This book reflects the law as it stood on 31 December 2018.