MAISTO E ASSOCIATI

TAX ALERT 1/2018

Major tax measures included in the Italian 2018 Budget Law

- **Amendments to the domestic definition of "permanent establishment";**
- **Introduction of a new tax on digital transactions ("Web Tax");**
- **Changes to the tax regime of dividends and capital gains from substantial shareholdings;**
- **Changes to the tax regime of dividends from entities resident in low-tax jurisdictions;**
- **Changes to the rules limiting the deductibility of interest expenses for corporate tax purposes;**
- **Changes to the rules governing the interpretation of deeds for Italian registration tax purposes;**
- **Changes to the VAT group regime.**

On 29 December 2017, Law No. 205 of 27 December 2017 ("Budget Law") was published in the Italian Official Journal. Some of its most significant tax measures are summarized below.

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Amendments to the definition of "permanent establishment"

The Budget Law amends the domestic definition of permanent establishment ("PE") and implements some of the guidelines set forth by the OECD in its Final Report on BEPS Action 7 to prevent the artificial avoidance of PE status through (i) the specific activity exemptions or (ii) commissionaire arrangements and similar strategies. In particular, according to the amended PE definition:

- The specific activity exemptions are explicitly restricted to activities that are actually preparatory or auxiliary;
- The activities performed by closely-related enterprises at one or more fixed places of business should be analyzed on an aggregated basis for the purpose of assessing whether they may qualify as preparatory or auxiliary, provided that the business activities carried on by the closely-related enterprises constitute complementary functions that are part of a cohesive business operation;
- Persons that, acting on behalf of non-resident enterprises, habitually conclude contracts, or participate to the conclusion of contracts that are routinely concluded by such enterprises without material modifications, may give rise to an agency PE, unless they qualify as independent agents;
- Persons that act exclusively or almost exclusively on behalf of one or more closely related enterprises do not qualify as independent agents.

Finally, the Budget Law introduces an anti-avoidance provision pursuant to which a PE is deemed to exist in cases of a significant and continuous economic presence in the Italian

territory that has been arranged in such a way that does not give rise to a physical presence in Italy.

How these changes will actually affect persons that are resident of countries having a double tax treaty in force with Italy depends on (i) how PE is defined in the relevant treaty, (ii) to what extent the BEPS Multilateral Convention, which Italy signed on 7 June 2017, will modify such treaty and (iii) whether these changes will be regarded by the Italian Revenue Agency and Courts as specific applications of the general anti-abuse rule.

Introduction of a new tax on digital transactions ("Web Tax")

While the OECD and the EU continue working on proposals for the taxation of digital economy, the Budget Law introduces a new tax on digital transactions ("Web Tax"), which applies to services supplied through electronic means to Italian enterprises and PEs of non-resident enterprises.

The Web Tax is computed as 3% of the gross payments due for the services (exclusive of VAT), regardless of where the transaction is concluded. Both resident and non-resident digital service suppliers are liable to the Web Tax, which is withheld by the customers (i.e., the resident enterprises and PEs that receive the services) upon payment of the consideration. However, the suppliers are not liable to the Web Tax if they do not exceed the threshold of 3,000 transactions during any given calendar year.

A decree, which the Ministry of Economy and Finance should issue by April 2018, will identify the "services supplied through electronic means". Based on a plain reading of the law, traditional e-commerce transactions should seemingly fall outside of the scope of the Web Tax.

The Web Tax will apply as of 1 January of the calendar year following the one in which the decree of the Ministry of Economy and Finance is issued (i.e., most likely as of 1 January 2019).

Changes to the tax regime of dividends and capital gains from substantial shareholdings

The Budget Law substantially aligns the tax treatment of "substantial" and "portfolio" shareholdings. A "substantial shareholding" is a shareholding representing (i) more than 20% (or 2% in case of listed companies) of the voting rights or (ii) a participation in the capital greater than 25% (or 5% in case of listed companies). A "portfolio" shareholding is a shareholding that is not a "substantial" shareholding.

This reform will especially have an impact on (i) resident individuals who do not hold shares in connection with a business activity and (ii) non-resident persons that do not hold shares through an Italian PE. In particular:

- Resident individuals will now be subject to a 26% final withholding/substitute tax on dividends and capital gains not only from portfolio shareholdings, but also from substantial shareholdings. Under domestic law, foreign taxes paid on foreign-sourced dividends or capital gains will not be creditable against this flat 26% tax. However, for foreign dividends received through Italian-based intermediaries, foreign withholding taxes will reduce the tax base of the 26% Italian tax. The new rules do not modify the tax regime of dividends and capital gains from shareholdings in entities resident of low-tax jurisdictions, which, save for certain exceptions, are fully included in the income tax base and subject to progressive taxation (with the possibility of a foreign tax credit).
- Non-resident persons will now be subject to a final 26% substitute tax on capital gains realized on substantial shareholdings in Italian resident companies, unless a double tax treaty prevents Italy from taxing the gain. Non-resident persons were already generally subject to a 26% tax withheld at source on dividends from substantial shareholdings in Italian resident companies.

As a general rule, the new regime will apply to dividends paid as of 1 January 2018 and to capital gains realized as of 1 January 2019. However, the old regime will continue to apply

to dividend distributions that are (i) paid out of profits realized until the fiscal year that was current on 31 December 2017 and (ii) declared between 1 January 2018 and 31 December 2022.

Changes to the tax regime of dividends from entities resident in low-tax jurisdictions

Dividends from companies resident of (or otherwise located in) low-tax jurisdictions are generally subject to corporate tax on their full amount when received by individuals or companies that are tax resident of Italy. For these purposes, a low-tax jurisdiction is a jurisdiction that (i) is not an EU or EEA member State and (ii) has a nominal tax rate lower than 50% of the Italian nominal tax rate (or grants a preferential tax regime to the distributing company leading to taxation lower than 50% of the Italian nominal tax rate). As this definition refers to the level of taxation in the foreign country, a jurisdiction may qualify as low-tax in a given year and then as non-low tax in a subsequent year.

In Circular Letter No. 35/E of 4 August 2016, the Italian Revenue Agency took the view that if the jurisdiction of the distributing company qualifies as low-tax in the year of the distribution, the dividends should be fully subject to tax in Italy, irrespective of whether the same foreign jurisdiction did not qualify as a low-tax jurisdiction when the company realized the profits that are distributed.

The Budget Law supersedes this interpretation and specifies that dividends distributed by a non-resident company out of profits realized in tax years when the company's residence jurisdiction did not qualify as low-tax jurisdiction are always subject to the more favorable ordinary regime (i.e.: 95% exemption for dividends received by resident companies and PEs; 41.86% exemption for dividends received by individual entrepreneurs and resident partnerships; and, subject to the exception mentioned in the preceding paragraph, 26% withholding/substitute tax for dividends received by resident individuals and not attributable to their individual business). The Budget Law also provides that, for these purposes, profits realized when the distributing company's residence jurisdiction did not qualify as low-tax jurisdiction are deemed to be distributed first.

In addition, the Budget Law introduces a new rule whereby dividends distributed by companies resident of low-tax jurisdictions are taxable only for 50% of their amount in the hands of Italian resident companies, if it is proven that the non-resident company carries on, as its main business purpose, an industrial or commercial activity tied to the local market of its residence jurisdiction. If the Italian resident company receiving the dividends controls the distributing company, it shall also be entitled, subject to the foreign tax credit rules and limitations, to an indirect tax credit for up to 50% of the underlying foreign corporate tax paid by the distributing company.

Changes to the rules limiting the deductibility of interest expenses for corporate tax purposes

As a general rule, and subject to specific exceptions for certain business sectors, for corporate tax purposes resident companies can deduct interest expenses up to an amount equal to 30% of their EBITDA. Based on the previously applicable regime, for these purposes the EBITDA could be increased by dividends received from non-resident controlled companies. The Budget Law retroactively removes this latter possibility in relation to tax years following the tax year current on 31 December 2016. This change is aimed at aligning the domestic regime on the limitation on interest deduction with Article 4 of the ATA Directive (Council Directive (EU) 2016/1164 of 12 July 2016).

Moreover, the Budget Law provides that brokerage companies (*società di intermediazione immobiliare*) may deduct, for corporate tax purposes, interest expenses only up to 96% of their amount. This change modifies the previous applicable tax regime, which allowed these companies to fully deduct interest expenses, and partially compensates the reduction of the applicable corporate tax rate (from 27.5% to 24%) that the Budget Law enacts for these companies. Also this amendment applies retroactively to tax years following the tax year current on 31 December 2016.

Changes to the rules governing the interpretation of deeds for Italian registration tax purposes

The Budget Law revises the rules governing the interpretation of deeds for the purposes of applying registration tax (and other transfer taxes such as mortgage and cadastral taxes).

As result of these amendments, a deed filed for registration with the Italian Revenue Agency must be interpreted for Italian registration tax purposes, save for very specific cases, (i) by looking only at the provisions contained in that specific deed and (ii) without taking into account non-textual elements, as well as clauses or provisions included in other deeds (even if related to the deed to be registered).

The changes should impact on the substantive approach taken by the Italian Revenue Agency – and upheld in some instances by the Supreme Court – in case of indirect transfers of going concerns executed through: (i) the contribution of a going concern to a NewCo in exchange for its shares; and (ii) the following sale of the shares in the NewCo to the final purchaser. Taken separately, the contribution and the sale of shares only trigger the registration tax at a lump sum amount (generally Euro 200 per deed). However, over the last decade, the Italian Revenue Agency has consistently combined the contribution and the sale and re-characterized the resulting two-steps transaction into a straightforward sale of going concern, which is instead subject to registration tax at proportional rates (between 3% and 15%, depending on the assets transferred).

As expressly indicated in the explanatory memorandum to the Budget Law, the changes should also prevent the Italian Revenue Agency from re-characterizing sales of 100% of the shares of a company into sales of the underlying going concern, which is another line of assessment that the Italian Revenue Agency sometimes adopts.

The Budget Law however clarifies that these changes do not prevent the Italian Revenue Agency from resorting to the Italian general anti-abuse rule, if the relevant conditions are met.

Changes to the VAT group regime

The Budget Law amends the Italian VAT group legislation (effective as of 2019 for elections made in 2018) to make it compliant with the principles laid down by the CJEU in case C-7/13 (*Skandia*).

To this end, the Budget Law modifies the Italian VAT legislation and provides for new deeming rules applicable to supplies of both goods and services. In particular, under the new rules goods and services supplied:

- Between (i) head offices or fixed establishments belonging to an Italian VAT group and (ii) a fixed establishment, or its head office, situated abroad will be treated as supplies between the VAT group and a person that does not belong to the Italian VAT Group;
- Between (i) head offices or fixed establishments belonging to a VAT group set up in another EU Member State and (ii) a fixed establishment, or its head office, situated in Italy will be treated as supplies between the foreign VAT group and a person that does not belong to that VAT Group.

For these purposes, the taxable base of the supply is deemed to be the “open market value” as defined in the VAT legislation.

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