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Italy has enacted several provisions that amend its corporate and personal income tax regimes in some significant ways. The most important changes enacted during the last three months of 2005 concern rules on the taxation of portfolio dividends received by individual shareholders and rules on the exemption from tax of gains from the disposition of nonportfolio stock by corporate shareholders (the participation exemption). That series of fiscal measures was dictated mainly by budget problems and hardly fits into the corporate income tax system, as the measures introduce inconsistencies and uncertainty.

Participation Exemption

Holding Period and Exempt Portion of Gain

The first measures were enacted with Law Decree 203/2005, and they apply to gains from dispositions of stock realized on or after October 4, 2005. (For prior coverage, see *Tax Notes Int'l*, Dec. 5, 2005, p. 907.)

In one change, the holding period required for the purpose of granting the tax exemption for gains from dispositions of stock has been increased from 12 to 18 months. However, the minimum holding period (12 months) has been retained for the purpose of denying stock losses and interest deductions. The result is an inconsistency between the inclusion of gains and the deduction of losses and interest regarding nonportfolio stock.

Previous law was based on a symmetry between the exemption of gains and the nondeductibility of losses (and the interest allocated to tax-exempt stock): Stock eligible for the participation exemption would generate either tax-exempt gains or nondeductible losses (and the interest allocated to that stock was nondeductible), while stock falling beyond the scope of the participation exemption would generate either taxable gains or deductible losses (and interest allocated to that stock was deductible). The trade-off for the exemption of gains was the nondeductibility of losses (and allocated interest), and taxation of the gains corresponded to the deductibility of losses (and allocated interest).

Under the new law, that symmetry has been broken as a consequence of the differentiated holding period, which is longer for the exemption of gains (18 months) and shorter for the nondeductibility of losses (12 months). Therefore, for stock owned for more than 12 months but less than 18 months, losses now are nondeductible while gains are fully taxable, and under the financial pro rata rule of section 97 of the Tax Code, interest allocated to stock owned for more than 12 months but less than 18 months is nondeductible, even though any gains regarding that stock are fully taxable.

The second change concerns the exempt portion of the gain, which initially was reduced from 100 percent to 95 percent, with 5 percent of the gain being taxable for corporate income tax purposes at a statutory rate of 33 percent (corresponding to an effective tax rate of 1.65 percent, the same as the tax rate on dividends paid to corporate shareholders). Law 284/2005, approved on December 3, 2005, reduced the exempt portion of the gain even further, to 91 percent (equal to an effective tax rate of 2.97 percent) for gains realized on or after December 3, 2005, and through December 31, 2006, and to 84 percent (equal to an effective tax rate of 5.28 percent) for gains realized on or after January 1, 2007.

Therefore, under current law, gains from dispositions of nonportfolio stock, for corporate income tax purposes, are treated as follows:

- gains realized through October 3, 2005: fully exempt (effective tax rate of zero);

- gains realized as of October 4, 2005, through December 2, 2005: 95 percent exempt (effective tax rate, 1.65 percent);
- gains realized as of December 3, 2005, through December 31, 2006: 91 percent exempt (effective tax rate, 2.97 percent); and
- gains realized from January 1, 2007, and beyond: 84 percent exempt (effective tax rate, 5.28 percent).

Gains realized by individual shareholders engaged in a trade or business, or regarding nonportfolio stock, are 60 percent exempt and 40 percent taxable. The law has not changed in that respect.

> ***The measures introduce inconsistencies and uncertainty.***

The new rules limiting the exempt portion of the gain stand in contrast to the general rationale of the participation exemption regime, which is to preserve the integration of corporate- and shareholder-level tax and to prevent the double taxation of corporate earnings that would otherwise arise as a result of the elimination of the full imputation system in force under previous law.

The fact is that under the pressure of budget problems and political speculation about the forthcoming general election, the participation exemption rules fell under criticism, and the government decided to limit their scope as a way to deflect the political argument that the exemption of gains was designed to benefit the rich, who could speculate in the stock market tax-free. That argument, although clearly wrong, had started to gain some political appeal, and the government increased the taxation of stock gains to silence it.

In light of the new law, multinationals and groups of companies should carefully plan the timing of corporate reorganization transactions and dispositions of stock that are expected to generate tax-exempt capital gains. Indeed, depending on whether the relevant transaction is carried out by the end of 2006 or later on, in 2007, the final tax may vary from 2.97 percent to 5.28 percent.

Taxpayers also should consider the opportunity to distribute accumulated earnings as dividends before restructuring or disposing of appreciated stock, as the effective tax rate on dividends to corporate shareholders is 1.65 percent, instead of the 2.97 percent/5.28 percent tax that would apply to capital gains. In the case of consolidated groups of companies, the presale distribution of dividends would be even more favorable, as dividends would be totally tax-exempt.

More generally, it is fair to assume that the tax increase for stock gains as a result of the extension of the holding period and the increase in the taxable portion of the gain should persuade taxpayers to change their tax planning strategies — from a preference for transactions that enjoy sale or exchange treatment and would generate capital gains now subject to a higher level of tax, to transactions that enjoy dividend treatment and would generate exempt (in the case of tax consolidation) or low-taxed dividend income.

Antiabuse Provision

The participation exemption rules provide that portfolio stock (that is, stock purchased for short-term investment purposes only and that is recorded as a portfolio asset on the shareholder's balance sheet) is not eligible for the exemption; therefore, gains and losses from the disposition of portfolio stock are fully recognized for tax purposes. In contrast, dividends distributed regarding portfolio stock are tax-exempt (up to 95 percent of their amount).

The discrepancy between the dividend exemption and gain/loss recognition regarding portfolio stock offered taxpayers easy tax avoidance opportunities. A typical transaction was the purchase of portfolio stock "cum dividend," the collection of a tax-exempt dividend (which offset the portion of the purchase price corresponding to the amount of the dividend already declared on the stock), and the immediate disposition of the stock at a loss that was fully deducted for tax purposes.

With Law 248/2005, the legislature closed that loophole by enacting an antiabuse provision under which losses from dispositions of portfolio stock, which generally would be fully deductible, cannot be deducted up to the amount of any exempt dividends received by the transferor regarding that stock during the 36-month period preceding the sale of the stock that generated the loss. Two points are worth noting here. The first is that the new rule is very wide in scope and also reaches bona fide commercial transactions entered into by stock and securities dealers, who are compelled to keep track of all their investments and dispositions of stock and of dividends paid regarding the various portfolios of stock, and are subject to tax on dividends even if they do not have tax avoidance purposes. The second is that more guidance must be provided on how the new rule should apply for stock acquired in different integrated transactions as part of the same plan across the tainted period.

Stock Basis Adjustments

Under previous law, taxpayers were able to write down the book value of subsidiaries' stock and deduct the loss for tax purposes. That possibility has been eliminated with the enactment of the 2004 corporate income tax reform. To avoid double benefits, the participation exemption rules provide that for gains realized in 2004 and 2005, the tax basis of the stock has to be adjusted downward to the extent of any unrealized losses deducted in 2002 and 2003, and the portion of gain attributable to those previously deducted losses is recaptured and subject to tax. Initially, the rule applied only to losses deducted in a specified period (that is, 2002 and 2003). However, a new provision inserted in Law Decree 2/2006 extended the recapture rule to all losses previously deducted in any tax years preceding the enactment of the participation exemption rule.

Determining Exemption Eligibility

If stock is acquired in separate but integrated transactions as part of an overall plan, the identification of the shares sold for the purpose of calculating the minimum holding period and possible eligibility for participation exemption treatment is made by treating the shares acquired last as being sold first (the last-in, first-out rule). In its initial guidance on that matter, the Italian tax administration took the position that if shares of stock acquired in integrated transactions are booked partly as fixed financial assets and partly as portfolio assets, the LIFO rule should apply on an aggregate, pro rata basis.

That interpretation penalized companies that own both strategic stock and portfolio stock that are engaged in the active trading of stock or securities. Indeed, the constant trading of portfolio stock would make it impossible for them to trace the sold stock to stock booked as a financial asset and to benefit from the participation exemption.

Legislative Decree 247/2005 contains an interpretive provision according to which, in the above situation, the LIFO rule applies on a separate, category-by-category basis. The provision applies retroactively from fiscal 2005.

Classification of Financial Instruments

A change that indirectly affects the application of the participation exemption rules and the dividend tax regime concerns the classification of financial instruments for tax purposes. Indeed, the benefits of the gain or dividend exemption apply only to payments received regarding an instrument that is classified as equity for tax purposes.

Under previous law, a financial instrument issued by a foreign entity would be classified as stock for Italian tax purposes if it met two requirements: it represented a participation in the capital of the company (that is, it was equity for company law purposes), and its remuneration consisted entirely of a participation in the profits of the issuer (the so-called double equity requirements). That provision left room for tax arbitrage opportunities. By properly exploiting the interaction between Italian and foreign law, related taxpayers could structure an instrument in a way that it was classified as debt and therefore generated deductible interest to the issuer under foreign law, and as equity, generating a tax-exempt dividend to the holder under Italian law, with the consequent double dip (a tax deduction in the state of the payer and a tax exemption in the state of the recipient).

> ***An instrument issued by a foreign company is classified as equity and generates tax-exempt dividends under Italian law if its remuneration is totally nondeductible to the issuer under foreign law.***

Those tax arbitrage opportunities have been shut down with a new provision in Legislative Decree 247/2007, according to which an instrument issued by a foreign company is classified as equity and generates tax-exempt dividends under Italian law if its remuneration is totally nondeductible to the issuer under foreign law. The requirement that it is also equity for company law purposes has been withdrawn.

The new provision adopts an "all or nothing" view, as opposed to a bifurcation approach that may produce unfavorable consequences for ill-advised taxpayers. An instrument whose return is partly fixed and partly determined with reference to the issuer's profits would be classified as debt for Italian tax purposes, and the whole amount of its return, including the contingent portion, would be fully taxable to the holder in Italy.

The application of the new law revolves around the tax treatment of the payments made regarding the instrument under foreign law. That implies an inquiry that often is very difficult to make.

The new provision applies to tax years beginning on or after January 1, 2006, and requires that multinationals and groups of companies engaged in cross-border operations review their financing structures to make sure that they maximize the tax benefits associated with cross-border intracompany financing and avoid the potential harsh consequence of no deduction in the foreign country, and full inclusion in Italy, regarding the same income.

Goodwill Amortization and Lease Payment Deductions

The Budget Law for 2006 increased the cost recovery period for goodwill from 10 to 18 years. The longer amortization period applies to fiscal 2005 and beyond, and it includes goodwill already recorded in the corporate books since that time, for which the existing cost recovery period must be recomputed accordingly. The new law does not affect the depreciation of other intangible assets, such as patents and trademarks, for which the depreciation schedule has not been changed. It must be noted that goodwill is amortizable only in the case of taxable asset deals that give the buyer a cost basis in the acquired property. In that case, to counter the effects of the slower cost recovery period for goodwill, taxpayers will have to try to structure the transaction in a way that allows them to allocate as much as possible of the purchase price to assets that have a faster depreciation schedule. Italy does not have tax rules on the allocation of the purchase price in cases of taxable asset purchases, like the rule of U.S. Internal Revenue Code sections 338 and 1060. The matter is governed by general commercial law principles that are subject to antiavoidance tests such as business purpose and economic substance.

Law Decree 203/2005 extended the minimum recovery period for the purpose of deducting rents paid under lease contracts for real property. Rents now are deductible on a pro rata basis over a period of 15 years (as opposed to 8 years, as provided under previous law), regardless of the actual duration of the contract for civil law purposes.

Asset Basis Step-Up

Stock and Fixed Assets

The Budget Law for 2006 provides for an election to book up fixed assets carried in the 2005 financial statement and to recognize the higher basis for tax purposes. The book-up and tax basis step-up are elective. By increasing the adjusted tax basis of the asset regarding which depreciation deductions and taxable gains are computed, taxpayers can generate higher depreciation deductions during the operation of the property and lower taxable gains on its disposition. The tax basis step-up requires the payment of a tax in place of the general income tax (substitute tax), computed at a rate that applies on the amount of the step-up, and it varies depending on the nature of the assets. The substitute tax rate is 12 percent for depreciable fixed assets (tangible and intangible), 6 percent for stock, and 19 percent for building land.

With the exception of building land (which is considered in the next paragraph), the substitute tax must be paid upfront (by June 2006 for calendar-year corporate taxpayers), while the benefits of the tax basis step-up are postponed to fiscal 2008 (and enjoyed in the tax return filed in 2009). That means that until 2008, depreciation deductions and taxable gains are computed with reference to the property's old adjusted tax basis, whereas in 2008 and beyond, depreciation deductions and taxable gains will be computed with reference to the increased tax basis inclusive of the step-up. Therefore, if booked-up property is disposed of before fiscal 2008, the benefits of the basis step-up will be entirely lost.

> ***Gains realized by individuals regarding portfolio stock are fully taxable if the stock is of a company organized in a blacklisted jurisdiction.***

In case of election, the amount of the tax basis step-up would be added to the asset's old adjusted tax basis, and the aggregate amount equal to the sum of the old basis and the basis step-up would be depreciated along the remaining depreciation period for that particular property. That means that for property with short cost recovery periods or property that is close to the end of its cost recovery period, the recovery of the stepped-up basis could be highly accelerated. In the case of intellectual property (patents, know-how, and so on) that has a maximum amortization rate of 33 percent, it may well happen that the basis step-up is immediately expensed in one year.

The law requires that a revaluation reserve equal to the amount of the book-up (net of the substitute tax) be credited to the equity on the balance sheet. The reserve cannot be distributed. If distributed, it would be entirely taxable, with immediate recognition of the step-up for tax purposes. The law allows the immediate release of the reserve with the payment of an additional 7 percent substitute tax. In that case, the reserve would be immediately distributable in 2006.

Determining whether electing for a tax basis step-up is beneficial to the taxpayer requires a calculation of the present value of the future benefits of the step-up (higher depreciation deductions or lower gains, postponed to 2008) and their comparison with the election's immediate costs (the substitute tax). Most likely, the tax basis step-up would be beneficial to companies that have developed and own valuable intangibles with a remaining short cost recovery period.

A favorable indirect effect of the tax basis step-up would be the immediate increase of the equity of the company as a result of the revaluation reserve to be credited to the book equity in the balance sheet, which would affect the computation of the 4-1 debt-to-equity ratio used to determine whether the thin capitalization rules apply. By increasing the equity of the fraction, the basis step-up would serve to prevent the application of the thin capitalization rules.

Before electing the basis step-up, U.S. multinationals will have to inquire into the nature of the Italian substitute tax to make sure that it can be credited in the United States as an "in lieu of" tax for U.S. foreign tax credit purposes.

Building Sites

The peculiarities of the tax basis step-up for building sites are that the substitute tax (charged at a rate of 19 percent) can be paid in three yearly installments without interest and that the basis step-up is immediately recognized for tax purposes. In that way, the owner can avoid the tax on the capital gain realized on the sale of the building site. On the other hand, the law requires that the site be developed in the next five years.

Taxation of Dividends From Portfolio Stock

Portfolio stock dividends paid to individual shareholders are fully taxable if the distributing company is organized in a low-tax jurisdiction that is on Italy's blacklist. Under previous law, those dividends were subject to a 12.5 percent flat-rate tax, like dividends paid by any other nonblacklisted companies. Similarly, gains realized by individuals regarding portfolio stock are fully taxable if the stock is of a company organized in a blacklisted jurisdiction. Previously, those gains were subject to the 12.5 percent flat-rate tax that also applied to portfolio dividends. ◆

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