Italy

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General

1. Recent tax developments which are relevant for M&A deals

Italy's corporate income tax rate (Imposta sul Reddito delle Società – IRES) is currently 27.5% but a new law states that the rate will be reduced to 24% for fiscal periods starting from 1 January 2017 onwards (with a 3.5% surcharge for banks and financial institutions, which will therefore maintain an aggregate 27.5% rate).

Italy applies also a regional income tax (Imposta Regionale sulle Attività Produttive — IRAP) which is applied on a taxable income specifically determined (the cost of labour is, from 2015, fully deductible from such a tax base). The rate applicable is 3.9%, which is raised to 4.65% for banks and financial institutions and 5.9% for insurance companies (further limited surcharges may be applied by each region).

Recent tax law amendments:

- the introduction of a patent box regime in line with OECD approach
- an exemption regime for foreign branches of Italian companies
- the full implementation of the OECD principles for the determination of the income of an Italian branch of a foreign company (distinct and separate approach based upon risks, functions and assets)
- the introduction of new types of rulings, including a special ruling for companies with considerable large investments to be realised in Italy (over EUR 30 million)
- a revision of the CFC legislation

Moreover, on 30 March 2016 the Italian tax administration issued a Circular which analysed various tax issues related to leverage buy-outs and private equity deals (including the tax deduction of interests on buy-outs and management fees charged by the private equity firms, the potential re-qualification of shareholder loans and the use of "conduit" companies or transactions).

2. General approach regarding the implementation of OECD BEPS actions and amendments to the EU Parent-Subsidiary Directive

Italian tax authorities are monitoring the BEPS Action Plan and some specific recommendations have already been introduced into Italian laws, like e.g.:

- obligation of the country-by-country reporting for Italian multinationals (over EUR 750 million turnover) and Italian subsidiaries if the controlling company is not subject to the same rule in its country or there is not a treaty allowing such exchange of information
- income paid by foreign companies may be taxable as "dividend" (i.e. substantially exempt) if it can be demonstrated that the same payment has not been deducted from the taxable income of the foreign company (rule against hybrid mismatches)
- a new anti-abuse rule, which unifies the previous anti-avoidance tax law and the jurisprudential concept of the abuse of law, was introduced in August 2015 and is applicable to transactions occurred after 1 October 2015 (and also prior to that date if the assessment is notified after that date). The new rule technically defines the concept of "abuse of law" according to the rules on aggressive planning and is in line also with the concepts described in the EU Parent –Subsidiary Directive

3. Main differences among acquisitions made through a share deal versus an asset deal

The main tax differences between an asset deal and a share deal may be summarised as follows:

- In an asset deal the capital gain (loss) realised by the selling company is taxable (deductible) for corporate tax purposes at IRES ordinary rates (in case of assets owned by more than three years, the gain may be deferred over maximum 5 tax periods) and is not subject to IRAP if the asset deal regards a going concern. In a share deal the capital gain (loss) realised by the selling company may benefit at certain conditions of the participation exemption regime (i.e 95% exemption of the gain and full non deductibility of the loss)
- In an asset deal the buyer acquires tax relevant values, i.e. it implies a step-up also for tax purposes in the depreciable basis of assets transferred corresponding to the purchase price paid allocated to each asset. In a share deal, in principle there is no step up of the assets value unless certain extraordinary transactions are realised and/or a specific option is exercised which imply the payment of a substitute tax
- In an asset deal the tax attributes (tax losses or interest not yet deducted carried forward) remain with the selling company and are not transferred to the buyer. In a share deal the said tax attributes carried forward stay with the company acquired, even if they are subject to certain limitation rules aimed to avoid the "trade of tax losses"
- In a share deal all the contingent tax liabilities remain in the company whose shares are sold for the statute of limitation period, i.e. 31.12 of the fifth year following the filing of the tax return for 2016 onwards (for tax periods until 2015 the reference is to the fourth year subject to a potential extension to eighth year in case of criminal proceedings) and therefore the buyer should in principle seek for guaranties of the tax risks
- In an asset deal the contingent tax liabilities relating to the assets or the going concern transferred remain as a general rule with the transferring company. However, pursuant to Article 14 of Decree no. 472/1997, the buyer of a going concern is jointly and severally liable with the seller for the most recent tax liabilities and anyway for an amount not exceeding the value of the assets. A tax certificate stating the amount of tax liabilities attached to the going concern can be asked to the tax authorities and the buyer's liabilities are limited to those resulting from it. The said liability rules do not apply if the asset deals occurs in a pre-bankruptcy regulated procedure
- The share deal is not subject to indirect taxes, except in case the shares sold regards an Italian joint stock company ("società per azioni") when a 0.2% tax (Tobin tax) has to be applied
- In an asset deal realised through the transfer of a going concern, transfer taxes are paid usually by the buyer, even if both parties are jointly and severally liable for the payment of registration tax (which is generally applied at a 3% rate, except for real estate assets mainly subject to 9%)

Buy-side

4. Strategies to step up the value of tangible and intangible assets in case of share deals

If the target company is subsequently merged with the acquiring company, the possible merger deficit (disavanzo di fusione), which represents the difference between the cost borne by the absorbing company for acquiring the shares of the merged company and the book value of its net assets, can be used to step up the value of the assets. Such accounting step up is not relevant for tax purposes unless the company exercises on of the following options regarding, in full or in part, one or more assets:

- according to the ordinary tax law applicable to mergers and other extraordinary "tax neutral" transactions (like contribution of business or demergers) the absorbing company is entitled to step up the tax value (for corporate income tax and IRAP purposes) of the fixed assets tangible and intangible received by paying a substitute tax at the rate of 12% on the portion of the step-up in value up to EUR 5 million, 14% on the portion of the step-up from EUR 5 million to EUR 10 million, and 16% on the portion of the step-up in value exceeding €10 million. The option for the step-up can be elected in the tax return of the year in which the merger has been done or in that of the following tax year. The step-up tax values are effective starting from the fiscal period in which the option is exercised, subject to a recapture rule if the assets are disposed within the fourth fiscal period following the one in which the option is exercised (i.e. the capital gain/loss is computed on the basis of the pre-step up tax values and the substitute tax paid is deducted from the ordinary income tax due)

- according to special provisions, the absorbing company is entitled to step up the tax value only of intangible assets (goodwill, trademarks and other intangible assets) by paying a substitute tax at the rate of 16% and obtaining a shorter depreciation period for goodwill and trademarks (see the following Section 4. for the consequences in terms of depreciation). This option for the step-up can be elected only in the tax return of the year in which the merger has been done and the tax step up is effective starting from the fiscal period following the one in which the option is exercised, subject to the same recapture rule described under the first point)
- moreover, a Decree allows the absorbing company to step up the tax value of assets other than the fixed assets; this may be done by paying ordinary taxes or, in the case of a step-up of receivables, by applying a substitute tax at a rate of 20%

Finally please note that the above step up tax effects described under b) above may be reached even without any merger with the target. In fact, if the Italian acquiring company includes the target in its consolidated accounts, attributing in such accounts the price paid also to intangibles assets, it may optionally decide to pay a 16% substitute tax and get a tax deduction based upon a fictitious depreciation of such intangible assets to be computed on shorter periods than usual (see the following Section 4. for the consequences in terms of depreciation). Also in this case the recapture rule above described is applied if the shares or the intangibles are disposed within the fourth fiscal period following the one in which the option is exercised.

5. Depreciation of goodwill

In an asset deal where a business as a going concern has been acquired and a price for goodwill has been paid, such goodwill can be recorded in the balance sheet and amortised for accounting purposes over its useful life, as properly motivated in the accompanying notes or, if such life cannot be reliably estimated, within maximum 10 years. For tax purposes, the goodwill must be anyway amortised in not less than 18 financial years.

In cases where the goodwill has been subject to the optional regimes and the taxpayer voluntarily pays the 16% substitute tax, the tax depreciation of the goodwill can be reduced to not less than five fiscal periods, irrespective of its accounting depreciation. Such tax depreciation is valid both for corporate income tax and for regional income tax purposes.

Please note also that trademarks are treated exactly as the goodwill (i.e. ordinary 18 years tax depreciation or accelerated five years tax depreciation in case one of the art. 15/185 regimes is applied).

6. Limitations to the deductibility of interest on borrowings

According to the Italian tax code net interest expenses (i.e., interest expenses less interest income) are deductible up to an amount equal to 30% of earnings before interest, taxes, depreciation and amortisation (EBITDA) as shown in the profit and loss statement. From 2016 onwards also dividends received from foreign controlled companies are included in the above EBITDA computation.

Interest expenses exceeding the 30% EBITDA threshold are not deductible in the relevant fiscal year and are carried forward in the following fiscal years (without any time limit) and may be deducted in a subsequent tax period if and to the extent the 30% of EBITDA is higher than net interest expenses in that fiscal year. If the 30% EBITDA does exceed net interest expenses, such exceeding EBITDA can be carried forward to offset in the future exceeding interest.

Excessive interest can be offset within a domestic fiscal unit in computing the total income within the group if (and to the extent) other companies within the group have their own 30% EBITDA exceeding their own interest expenses.

In a merger or a demerger, excess interest carried forward is subject to the same limitations imposed for the carrying-forward of tax losses (i.e., the net equity test and vitality test mentioned in Section 8.).

The above is applicable only for corporate income tax (IRES) while for regional income tax (IRAP) interests are fully non-deductible (except for companies of the financial sector).

The above regime is not applicable to companies operating in banking, finance, insurance and other particular industries listed by the law, for which only 96% of interest expenses accrued is tax-deductible both for corporate income tax (IRES) and regional income tax (IRAP). However, starting from 2017 for banks and financial entities interests will become fully deductible for both income taxes (IRES and IRAP).

Interests paid to foreign companies of the same group would be then subject to the transfer pricing rules as regards the application of an arm's length interest rate or, in special circumstances, the re-qualification of a loan into equity according to OECD Guidelines.

7. Strategies to push down debt on acquisitions

Commonly, an acquisition of shares in an Italian target company is made through a leveraged buyout and through the merger of the acquiring company and the target the debt is pushed down into the surviving company, and interest expenses accrued on it are utilised to offset revenues generated by the target.

In recent years the deduction of interests or transactions costs in a leveraged buy-out has been challenged by the tax authorities by considering them abusive tax schemes or by denying the inherence of the acquisition costs/ interests of the acquisition debts. Although a consistent position is not yet formed, the jurisprudence has generally denied the validity of the tax assessments.

In a Circular, the tax administration has partially reverted its position and has recognised the general tax validity of the leverage buy-outs and the deduction of related interests, unless in purely artificial structures.

If, for whatever reason, a merger is not feasible, another option is to consolidate the new company and the target company in a domestic fiscal unity. In doing so, the target's tax position (hopefully a taxable income position) can be offset by the new company's tax position (usually a tax loss position, due to interest expenses accrued on the debt).

The upstreaming of dividends may be another available strategy, taking into account that dividends are taxable only on 5% of their amount.

In formulating the strategy for the acquisition, attention must be paid to the limitations to the deductibility of interest on borrowing and to the "abuse of law" discipline.

8. Available losses after an acquisition

Such issue may regard only share deals since in an asset deal the tax losses always remain with the selling entity.

In principle tax losses can be carried forward without any time limit but can be used to offset the taxable income only within a 80% threshold, e.g.: given a taxable income for 100 and losses for 120, these losses can offset the income only up to 80 (80% of 100) and the remaining 40 loss (120 – 80) can be further carried forward without any time limit. Tax losses suffered in the first three years from the set-up of the company are not subject to the 80% threshold.

Limitations to the carrying forward of tax losses apply to the transfer of shareholdings and to mergers and demergers, as follows:

- no loss carry-forward is allowed and losses are "lost" when the following conditions are both met
  - the majority of the voting shares in the company that is carrying forward losses is transferred, and
  - the main activity carried on by the company is changed from the one carried on in the fiscal years when losses were suffered. The change in the activity has to occur in the year the shares are transferred or during the previous two or the following 2 years

Nevertheless, even if the above conditions are met, a company can still carry forward losses if, during the two years before the transfer of shares, it did not reduce employees below 10 units and it exceeds in the profit and loss statement of the previous year certain thresholds ("vitality test").

in a merger (or demerger), tax losses carried forward by companies involved are available for the absorbing company (i.e., the surviving entity) after the merger, on the condition that both the "vitality test" (see above) and the "net equity test" (i.e. losses cannot exceed the net equity computed without taking into account any contributions and payments to equity made during the prior 24 months) are passed.

9. Indirect taxes

In a share deal, no stamp duty or registration taxes are due (only fixed non material amounts could be due). However starting from 1 March 2013, a Tobin tax has been introduced in Italy at a 0.20% rate and it is applicable also to the transfers of shares of joint stock companies ("società per azioni") even if executed outside financial markets.

In an asset deal, transfer taxes are paid usually by the buyer, even if both parties are jointly and severally liable for the payment of registration tax. Indirect taxes depend upon the type of transaction:

- in case a going concern is transferred, a registration tax is applied on the market value of the assets transferred, including goodwill, net of liabilities transferred as reported in the accounting books of the company. The applicable tax rate depends on the nature of assets transferred. Movable property, goodwill, patents and trademarks, inventory, etc., are taxed at the rate of 3%, while real estate assets are taxed mainly at the rate of 9%
- in case of the transfer of an isolated asset (i.e., not a business as a going concern), if the seller is a VAT-taxable person the transactions would be likely subject to VAT or in the opposite case of a non VAT seller (i.e. outside the exercise of a business activity), it should be liable to registration tax (VAT and registration tax are in principle alternative)

In terms of financing acquisitions, any bank loan which lasts for more than 18 months and is granted by an Italian bank could be optionally subject to a 0.25% substitute tax (imposta sostitutiva) applied on the amount of the loan. This tax substitutes other indirect taxes due on guaranties like mortgages, pledges, etc., related to the bank loan.

10. Restrictions on the tax deductibility of acquisition costs

In an asset deal the transaction costs are normally tax deductible if they are inherent to the business activity of the acquiring company. Advisory fees, banking fees, due diligence fees, legal and tax fees related to the asset deal are in principle considered as expenses to be recorded in the yearly profit and loss or capitalised as pluriannual multi-year costs to be depreciated in the fiscal periods of their estimated useful life (usually 5 years), depending whether such costs are related or not to future business profits.

In case of a share deal, it has to be analysed if the transaction costs above mentioned are in principle related to the acquisition of the participation or to the financing received for the acquisition or are sustained for both purposes. The costs directly related to the participation are usually capitalised as ancillary cost of the participation (and therefore they are not tax deductible) while the costs related to the borrowings are treated as ancillary costs of the financing and are deductible over the duration of the financing.

The said tax treatment does not change if the acquisition is followed by a merger since the costs allocated to the participation would become a not tax relevant merger deficit while the ancillary costs of financing would continue their deductible depreciation.

11. VAT recovery on acquisition costs

In case of a share deal, the treatment of the VAT paid on acquisition costs depends upon the general principles of VAT, i.e. the VAT paid on such service costs must have a direct and immediate link with the output transactions.

According to article 4 of Italian VAT Law, no VAT can be deducted if the acquiring company is a holding company operating without any direct structure aimed at exercising financial activities or other activities of direction and coordination or management activities in the participated companies. If instead the holding actively intervenes in the management of its participated companies, it may be deemed to exist the said link with the VAT output transaction and therefore VAT paid may, in principle, be recovered.

In case of a merger leverage buy out, although the holding used for the merger does not have usually any structure, the doctrine is inclined to support the VAT deductibility since the merger is a necessary part of the deal and allows the direct and immediate link with the target's operations. In Circular n. 6/2016 the tax authorities seems to require also in this case that the activity of the vehicle company is not limited to the pure holding of the participation.

In case of an asset deal, VAT paid on acquisition costs is in principle deductible from VAT due, unless the going concern exercises a VAT exempt activity.

12. Special considerations in acquisitions by foreign companies

As regards repatriation of profits and exit, it has to be considered that dividends paid outbound are subject to a 27% w/h tax, unless in the following cases:

- no withholding tax is applied on dividends in cases where the EU Parent-Subsidiary Directive is applicable (i.e. an EU parent company has held at least a 10% stake for one year in an Italian subsidiary company); if the ultimate shareholder is an extra-UE entity, the tax authorities may ask the company to prove that the exclusive or main purpose of the use of an UE holding was not the benefit of the parent-subsidiary directive;
- a 1.375% withholding tax applies on dividends paid to UE companies or to companies of the European Economic Area giving exchange of information, if they are subject to ordinary income tax in their country (reduced to 1.20% from 2017 onwards) ;
- a reduced rate (generally 5% or 10%) may be provided by the applicable tax treaty signed by Italy.

In terms of exit, the capital gain realised by a foreign company selling shares of an Italian target is usually protected from taxes in Italy according to the applicable tax treaty.

In case the acquisition is made by a foreign company, special attention must be paid with the use of foreign holding companies which should have general substance requirements in order to support their foreign tax residence (see Section 17).

13. Reorganising after an acquisition

Italian law provides for a tax-neutral regime applicable to some qualifying corporate restructurings, such as mergers, spin-offs, contributions-in-kind and exchanges of shares. Under this tax-neutral regime, a deferral of capital gains taxation is allowed and the acquiring entities receive a carryover basis in the assets acquired.

The main caveat to tax-neutral restructurings is the new rule regarding the "abuse of law" which is applicable to transactions lacking of economic substance which realise undue tax benefits and that can be consequently disallowed by the tax administration. The lack of economic substance regards facts, acts or agreements which do not produce any significant effect other than the tax saving, e.g. the use of juridical instruments not coherent or not adherent to market practice. An undue tax benefit occurs when it is realised in contrast to the specific tax rules or general principle of the tax discipline.

Taxpayers may ask for a ruling to determine if the transactions that they are about to carry out may constitute abuse of law. No criminal charges would be linked to the "abuse of law" behaviour.

14. Special considerations for companies whose main asset is real estate

In case of a share deal it has to be taken into account that the favourable participation exemption regime for the selling company (see Section 15) does not apply to the transfer of shares in real estate companies, and capital gains on these transfers are subject to corporate income tax at the ordinary rate.

A real estate company is defined a company having the value of its assets mainly represented (i.e., more than 50%) by real estate from the beginning of the third fiscal year before the shares are sold. Properties used for the purpose of a commercial activity are not deemed to be real estate assets for capital gain purposes.

In case of an asset deal made by a VAT subject, the sale of a commercial real estate is VAT exempt or, by option of the seller, is subject to ordinary VAT with the reverse charge system; anyway, a 3% cadastral and a 1% mortgage taxes are due in such case.

In case of a sale realised by a non VAT subject, the sale is subject to registration tax at 9% rate in case of a commercial building and 12% in case of agricultural land (cadastral and mortgage tax are applied for a fixed amount of EUR 200 each).

Sell-side

15. Taxation of capital gains

Italian companies are entitled to the 95% participation exemption (i.e. only 5% of the capital gain is subject to IRES tax) if the following requirements are met:

a) the shareholding has been held at least from the first day of the 12th month prior to the disposal

b) shares have been booked by the seller as a long-term investment (fixed financial asset) in the first balance sheet of the holding period (no minimum percentage is required)

c) the participated company is not resident of a tax haven

d) the participated company is exercising a real business activity. Companies with assets mainly represented by real estate not used in the business activity are deemed not to perform a real business activity under the "active business" test

The above requisites under letters c and d must be fulfilled starting from the beginning of the third fiscal period prior to the sale.

Lacking any of the above conditions, the capital gain is fully subject to IRES corporate income tax in the same year or, if the shares were booked as fixed financial assets in the last three financial years, over a period up to five years.

For individuals resident in Italy, the taxation of capital gains in Italy depends on the level of shareholding, as follows:

- If the individual sells a "qualified" participation, i.e. more than 20% of voting rights or 25% of the paid-in share capital in the company if the company is not listed at the stock exchange and respectively 2% and 5% if the company is listed, the capital gain is subject to personal tax for 49.72% (i.e. 50.28% exempt). The taxable capital gain is subject to tax according to the progressive scale of rates, with a maximum tax rate of 43% (for income exceeding €75,000) and a 3% surcharge in income exceeding € 300,000
- if the individual sells a "non-qualified" participation, the capital gain is instead subject to a 26% substitute tax

For foreign companies, the sale of a "qualified" participation is subject to IRES tax for an amount equal to 49.72% of the gain (subject to tax treaty exemption) while "non-qualified" participations sold by foreign companies located in "white list" countries (with exchange of information with Italy) are exempt from corporate tax according to our domestic law.

However, if a tax treaty is applicable, the capital gains are usually taxable only in the foreign country (except exceptions in certain treaties and subject to the substance requirements mentioned in Section 17).

16. Reinvesting proceeds from a sale

For companies, there is no specific fiscal advantage if the proceeds from the sale of shares are reinvested.

For individuals, non-profit entities and non-resident taxable persons Article 68(6-bis)(6-ter) provides the exemption of the capital gains realised upon the disposal of both qualifying and non-qualifying participations in stock companies and partnerships, provided that:

- the participated entity has been set up for no more than seven years
- the shares sold were held for at least three years, and
- the capital gains realised are reinvested in another Italian resident company or partnership operating in the same business sector and incorporated within the previous three years. The new investment must be made through the subscription or acquisition of the capital of such companies and within two years from the disposal of the participations previously held

However, the amount of the exempt capital gain cannot, in any case, exceed five times the costs borne by the company to which the transferred shares refer during five years preceding the disposal, for the purchase or the production of depreciable assets (intangible or tangible, excluding real estate properties) or for research and development activities.

17. Local substance requirements for holding/finance companies

According to our domestic rules, a company is tax resident in Italy if at least one of the following conditions are met:

a) it's registered place is in Italy

b) it has the place of administration in Italy (i.e. where strategic decisions are taken)

c) the main place ofactivity is in Italy

Moreover, there is a general presumption according to which a foreign company is deemed to be tax resident in Italy if the following conditions are both met:

a) the foreign company directly controls an Italian resident company and

b) the foreign company is directly or indirectly controlled by Italian residents or its Board of Directors is mainly formed by Italian resident individuals

If the above two conditions are met, the burden of the proof that the foreign company is not tax resident in Italy is shifted on the foreign company itself.

Moreover, the payment of dividends/interests/royalties from Italian companies to foreign holding/finance companies usually requires that the foreign company is the beneficial owner of the payments in order to apply reduced rates also according to the tax treaties.

Please note that, as regards capital gains realised by or dividends paid to foreign companies, the tax authorities have expressed the opinion that the tax treaties or directives or domestic reduced w/h tax would not be applicable in case of pure artificially structures and transactions, e.g. companies not economically rooted in the foreign territory or conduit transactions without non marginal economic (not fiscal) reasons.

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