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Italy

by Alessandro-Adelchi Rossi

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2008
YEAR IN REVIEW

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After a few years, during which Italy has tried to achieve a more comprehensive and internationally competitive income tax, 2008 has seen this fine-tuning process continue.

Legislation

A number of tax measures introduced in 2007 became effective during 2008. Italy's corporate income tax (IRES) and regional income tax (IRAP) rates were reduced to 27.5 percent (down from 33 percent) and 3.9 percent (down from 4.25 percent), respectively. However, the corporate income tax rate for entities engaged in oil-related businesses and with sales greater than €25 million has been increased to 33 percent.

The Italian withholding tax on dividends paid by an Italian entity to European Union residents was reduced from 27.5 percent to 1.375 percent, effective in early 2008.

Effective January 1, 2008, new interest rules replaced the previously applicable thin capitalization provisions. Under the new rules, interest expenses are now deductible up to an amount no greater than 30 percent of EBITDA (earnings before interest, taxes, depreciation, and amortization). The disallowed interest expenses, except for those generated in 2008 and 2009, may be carried forward indefinitely and deducted in a later year. The above limitation rules do not apply to banks and insurance companies that can now deduct 97 percent of their interest expenses.

Starting in 2008, the participation exemption provisions were relaxed by increasing the exemption to 95 percent of qualified capital gains. Favorable stock option rules under article 51(2)(*g-bis*) of the Italian Income Tax Code were repealed in 2008. As a result, when stock acquired through the exercise of an option is sold, the gain is treated as ordinary income to the employees.

Legislation amending the taxation of real estate investment funds has been introduced. Under Law 133/08, changes include a new 1 percent property tax applicable to funds' net assets, a withholding tax increase from 12.5 percent to 20 percent on the distribution of profits from a fund, and an increase from 12.5 percent to 20 percent of the capital gains tax rate applicable to a sale of an interest in a family real estate fund.

A tax exemption has been introduced for investments in start-up entities made by individuals, nonprofit entities, and non-Italian resident persons not engaged in an Italian trade or business through a permanent establishment. Under the new rules, capital gains realized on the sale or exchange of stock in a corporation formed within the seven-year period preceding such sale or exchange are generally exempt if a three-year holding period requirement is met and if the sale proceeds are rolled over in another Italian resident entity engaged in a similar business and recently incorporated.

New tax accounting rules have been introduced to reduce discrepancies between taxpayers' book and tax results, most notably in connection with depreciation.

EU Developments

On October 16, 2008, the European Commission announced that it is bringing a European Court of Justice challenge against Italy over Italy's discriminatory excise taxation of regenerated lubricating oils. Despite the commission's request to ensure equal treatment of domestic and foreign products in accordance with article 90 of the EC Treaty, Italy has not taken timely action to extend the tax advantage granted only to lubricating oil made from used oil collected in Italy.

In *European Commission v. Italy* (C-132/06) (July 17, 2008), the ECJ ruled against Italy's 2003 VAT amnesty. The court found that Italy violated articles 2 and 22 of the Sixth VAT Directive by absolving taxpayers from filing complete VAT returns and keeping complete VAT books and records under the provisions of a 2003 VAT amnesty program.

Also, the European Commission is reviewing the validity of tax advantages afforded to Italian ''cooperative'' entities. On June 17, 2008, the commission asked Italy for information regarding its preferential tax regime for cooperatives operating in the retail, distribution, and banking sectors to check whether it constitutes existing state aid, which would contravene EU law. While the commission generally recognizes that cooperatives have specific features that distinguish these entities from profit-making companies and justify a more favorable tax treatment, in the commission's view, preferential tax treatment may in some instances qualify as unlawful state aid. If certain tax benefits are so found by the commission, Italy may need to amend its tax regime for cooperatives.

Treaties

Yet another year went by without the pending Italy-U.S. tax treaty, signed on August 25, 1999, and ratified with a reservation by the U.S. Senate that same year, seeing the light of day. The pending treaty would replace the existing treaty that was signed in 1984. Italy, however, has yet to ratify the treaty. The U.S. Treasury is holding discussions with the Italian government about moving forward on the ratification process.

A sticking point for the Italians is what to do with the creditability of the IRAP, an Italian regional tax that would not be creditable under U.S. domestic rules. Under the current Italian treaty, the IRAP is creditable under a formula laid out in a temporary agreement signed between the competent authorities.

During 2008, Italy ratified the income tax treaty signed with Iceland on September 10, 2002. The treaty will enter into force on January 1, 2009.

Also, 11 years from the date on which it was signed (April 21, 1997), the income tax treaty with Latvia entered into force on June 16, 2008. This is the first income tax agreement concluded between the two countries. Its provisions will generally apply beginning January 1, 2009.

Finally, the income tax treaty signed with Armenia on June 14, 2002, entered into force on May 5, 2008. Its provisions will apply from January 1, 2009. The treaty generally replaces the income tax treaty concluded between Italy and the former Soviet Union. ◆

♦ *Alessandro-Adelchi Rossi is with Funaro & Co. PC in New York.*