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by Alessandro-Adelchi Rossi

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PRACTITIONERS' CORNER

Changes to Italy's Net Operating Loss Carryover Rules

by Alessandro-Adelchi Rossi

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To ameliorate the drastic consequences posed by a five-year net operating loss carryover limit on corporations experiencing losses at a time of an unprecedented downturn in the economy, Law No. 111 was passed on July 15, 2011, to lift the limit previously imposed under article 84 of the Italian Income Tax Code (Testo Unico delle Imposte Dirette, or TUIR).

The new statute was designed to permit corporations to set off their lean years against their lush years by allowing them to carry over their NOLs indefinitely, a feature previously available only for losses generated by new businesses during the first three years of operations.

In return for the unlimited carryover, however, article 84 now extracts as a price that the NOL deduction may not offset more than 80 percent of a corporation's taxable income for the year. Losses generated by new businesses during the first three years of operations are not subject to the 80 percent limit.

In the absence of a rule grandfathering the five-year limit for losses generated through 2010 and still available, it is unclear whether the new wording of article 84 also applies to the old NOLs.

The Research Institute of the Consiglio Nazionale dei Dottori Commercialisti (CNDC), the national professional governing body for Italian tax accountants, on September 14, 2011, issued Circular Letter No. 24/IR. According to the circular, the new rules should also apply to losses generated before the 2011 tax year.

The value of the CNDC's Research Institute interpretation should be seen against the backdrop of Italian administrative and judicial practice. Italian tax law does not have the detailed set of regulations, rulings, other published notices, and judicially developed anti-avoidance doctrines found in the tax systems of other countries. In this context, interpretations by the CNDC's Research Institute, the group of professionals that have traditionally dominated the tax profession in Italy, are a welcome addition.

Another issue raised by the new statute is whether the statute of limitations prevents the Italian revenue agents from examining the return of a closed year if its loss is carried forward and used in an open year.

Under article 43 of Presidential Decree 600/73, the statute of limitations for an assessment for the underpayment of tax generally expires on December 31 of the fourth year following the year in which a return was filed.

Assume that, under the new rules, in 2011 a corporation uses a loss carried forward from 2005. It would appear from the limitations rules that the Italian Revenue would not be able to audit the 2005 return because 2005 is a closed year. This is the conclusion reached by an Italian Tax Court (Commissione tributaria regionale del Veneto, sezione IV) on June 12, 2007, with Decision No. 18.

Our American readers might be surprised by this result, as in the United States the courts have held that the Internal Revenue Service may determine the validity of a loss incurred in a closed year if it is carried forward and used to offset income earned in an open year. The rationale for this seeming breach in the limitations rules is that the items on the return of the closed year are one of the facts to be examined in determining the validity of the return of the open year. Thus, in the United States, the statute of limitations

does not prevent the IRS from examining the return of a closed year if its losses are carried forward and used in an open year.

On the other hand, according to CNDC's Circular Letter No. 24/IR, in Italy the concern is to avoid unduly diluting the general period of limitations for the assessment of tax. The risk of taxpayers' manipulation of their NOLs and the timing of their use is instead addressed by putting emphasis on monitoring losses as they are reported. Under Decreto Legge (Law Decree) No. 78/2010, Italian revenue agents are mandated to closely monitor businesses, including start-ups, that report losses (not attributable to fees paid to directors and shareholders) on their tax returns for at least two years. ◆

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