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DATELINE

ITALY ISSUES GUIDANCE ON TAXATION OF DIVIDENDS UNDER NEW CORPORATE INCOME TAX

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The Italian government, on December 12, 2003,[1] introduced IRES (*imposta sul reddito delle societá*), the new corporate income tax that, effective January 1, 2004, replaced IRPEG (*imposta sul reddito delle persone giuridiche*), Italy's former corporate income tax.[2] One of the key features of IRES is the repeal of the tax credit mechanism[3] as the method to avoid double taxation of dividends and the introduction of a dividend-received deduction.

On June 26, 2004, the Italian Ministry of Finance issued *Circolare Ministeriale* No. 26/E, with guidance on the new rules regarding the taxation of dividends and much-needed explanation of the new tax laws in the context of the broad tax reform enacted by Finance Minister Giulio Tremonti on behalf of the Berlusconi government. The guidelines contain in-depth analysis of many issues facing taxpayers and Italian intermediaries including clarification on how to determine the character (i.e., dividend vs. return of capital) of corporate distributions to shareholders. In addition, the Ministry of Finance confirmed that the tax treatment of dividends also applies to income from certain financial instruments. The discussion below examines the tax treatment of dividends for corporate and individual taxpayers and outbound dividend distributions.

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Corporate Taxpayers

Corporate taxpayers are generally entitled to a 95% dividend-received deduction for dividends received from both resident and nonresident companies.[4] While the current corporate tax rate is 33%, dividends are subject to an effective rate of 1.65% (33% x 5%).

However, for dividends received from companies that are residents of a tax haven,[5] the dividend-received deduction does not apply unless a favorable ruling has been obtained from the Italian tax authorities. Also, dividends received by corporate taxpayers that have opted for group consolidation or flow-through status are fully tax exempt.

Individual Taxpayers

For individual taxpayers, the taxation of dividends varies depending on whether they are earned in connection with the individual's trade or business or portfolio investments. Dividends received from companies that are residents of a tax haven are subject to special rules.

Dividends earned in connection with a trade or business. These are subject to a 60% dividend-received deduction. The 40% portion of the dividend is subject to ordinary income tax rates.[6]

For dividends distributed by foreign entities, the guidelines explain that a 12.5% withholding tax applies to the taxable amount (40% portion) of the dividends received, net of foreign withholding taxes, if any. The tax is withheld by the Italian resident intermediary (i.e., bank or financial institution).

On filing the annual tax return, taxpayers are entitled to offset the domestic withholding tax and foreign withholding taxes, if any, in computing their final tax liability.

According to the Ministry's guidance, for purposes of computing the ultimate Italian tax liability and applying the foreign tax credit, foreign withholding taxes must not exceed the maximum rate applicable under the relevant income tax treaty.

Portfolio dividends. The tax treatment of portfolio dividends varies depending on the taxpayer's percentage ownership of the issuer.

Qualifying dividends. Qualifying dividends are dividends arising from shareholdings representing (1) more than 2% or 20% of the voting rights of the issuer, for listed and non-listed companies, respectively; or (2) more than 5% or 25% of the capital of the issuer, for listed and non-listed companies, respectively. Qualifying dividends are subject to the same rules (discussed above) as dividends earned in connection with a trade or business.[7]

Ordinary dividends. Ordinary dividends (i.e., dividends that are not "qualifying dividends") are subject to a 12.5% withholding tax in lieu of the ordinary income tax.[8] The tax is withheld by the Italian issuer.

For dividends distributed by foreign entities, the tax is withheld by the Italian resident intermediary (i.e., bank or financial institution). Absent an Italian resident intermediary (e.g., when an individual receives the dividends directly on a foreign bank account), individual taxpayers must remit the 12.5% withholding tax with the filing of their annual income tax return.

Also, the Italian withholding tax cannot be offset by foreign withholding taxes. However, the guidelines explain that the 12.5% withholding tax is applied on the amount of dividends received, net of any foreign taxes withheld. Any subsequent refund of foreign withholding taxes constitutes taxable income to the recipient.

Outbound Distributions

The Ministry's guidance confirms the general applicability of the 27% domestic withholding tax on outbound dividend distributions.[9] An exception applies for dividends arising from a special class of shares (*azioni di risparmio*), which are subject to 12.5% withholding tax. Of course, domestic withholding rates can be reduced in accordance with tax treaty provisions.[10] Also, a nonresident taxpayer may apply for a refund of 4/9 of the 27% withholding tax if it can prove that the dividend was subject to tax in a foreign jurisdiction.

Exemptions from withholding. No withholding applies to dividend distributions arising from investments that are attributable to the foreign person's Italian permanent establishment. Also, no withholding tax applies on dividend distributions to qualifying EU shareholders, pursuant to the EU parent-subsidiary Directive.[11]

Conclusion

The abandonment of the imputation system will clearly reduce complexities and related tax compliance costs, but most Italian individual and corporate taxpayers will generally suffer a slightly increased tax burden on dividend distributions. The reform of dividend taxation is only a small part of an ambitious and general reform of the Italian tax system that is in the process of being completed. One of the goals of the reform is to reduce the overall tax burden on companies and individuals. Foreign investors without an Italian permanent establishment can be sure that the taxation of Italian-source dividend distributions remains substantially unchanged. Nevertheless, the exact tax impact must be carefully reviewed in light of each specific ownership structure. ●

1 See *Decreto Legislativo* no. 344 of December 12, 2003, published in the *Gazzetta Ufficiale* no. 291, December 16, 2003.

2 For prior coverage, see Ferrol and Serao, "Major Italian Corporate Tax Reform Includes Repeal of Dividend Imputation Credit System," 15 JOIT 42 (January 2004).

3 Under the prior rules, individual or corporate shareholders were entitled to a credit against their own tax liability on the dividend income equal to the corporate tax paid (or deemed paid) underlying the dividend. The credit was first added back to the dividend received, for purposes of computing the taxpayer's taxable base, and then subtracted from the taxpayer's tax liability.

4 See article 89(2) of *Decreto del Presidente della Repubblica* (D.P.R.) 917/1986, *Testo Unico delle Imposte sui Redditi* (TUIR).

5 A blacklist of countries (or territories) with privileged tax regimes was published in a Ministerial Decree (November 21, 2001).

6 See TUIR articles 59 and 47(1).

7 See TUIR article 47(1).

8 See D.P.R. 600/1973, articles 27(1) and (4).

9 *Id.*, article 27(3).

10 The Italian Supreme Court (*Corte di Cassazione*), in Decision no. 1231 (October 26, 2000, published January 29, 2001), ruled that nonresidents claiming a reduced dividend withholding rate under a tax treaty are not required to comply with the requirements (e.g., proof of payment of tax in the country of residence) to obtain a refund of dividend withholding tax under Italian domestic law.

11 435/90/CEE (July 23, 1990). See D.P.R. 600/1973, article 27-*bis*.