



Italy Clarifies Participation Exemption Regime for New Corporate Income Tax

by Luigi Perin

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by Luigi Perin

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In 2003 the Italian government enacted IRES (*imposta sul reddito delle società*), the new corporate income tax that, effective January 1, 2004, replaced IRPEG (*imposta sul reddito delle persone giuridiche*). Among IRES's key features is the exemption from the corporate tax base of capital gains and losses arising from the disposition of corporate shares and investments in other entities (the participation exemption). The policy goal is to level the playing field for Italian holding companies by providing them with tax benefits similar to those in effect in other EU jurisdictions such as Austria, Belgium, Denmark, Luxembourg, and the Netherlands. (For prior coverage, see *Tax Notes Int'l*, Jan. 5, 2004, p. 52.)

On August 4, 2004, the Italian Ministry of Finance issued *Circolare Ministeriale* 36/E, which included detailed guidelines addressing the participation exemption regime.

Qualification Requirements

The beneficiaries of the participation exemption are Italian corporations and Italian permanent establishments of foreign entities that are subject to IRES.¹ The participation exemption applies to the disposition of interests in Italian and foreign entities, including shares of corporations and qualifying partnership interests.

For the seller to qualify for the participation exemption, all of the following conditions must be satisfied.

Condition 1. Seller's Holding Period

The seller must have held the shares uninterrupted from the first day of the 12th month preceding the month in which the shares are sold. For

¹A partial participation exemption applies to individuals who are subject to the Italian personal income tax, which is not the subject of this article.

multiple sales over a period of time, a last-in, first-out criterion applies in determining to what extent this condition is satisfied.

Condition 2. Financial Statements Classification

The shares that are being sold must have been reflected among the long-term assets in the first postacquisition financial statements of the seller.

Condition 3. Tax Havens

The company whose shares are being sold must not be a resident of a blacklisted tax haven or must have obtained a favorable ruling from the Italian tax authorities regarding its tax status in the tax haven.

Condition 4. Commercial Business

The company whose shares are being sold must have been actively engaged in a commercial business, as defined under the law, for a minimum lookback period.

The regular lookback period is three full tax years immediately preceding the year of the sale. For companies that exist for periods of less than three years, the lookback period is the period from the date of incorporation through the date of the sale of the shares. The law provides that the commercial business requirement is considered to be satisfied for shares of companies that are listed in a stock exchange or that have been sold under an initial public offering.

Shares of Real Estate Companies

Although the first three conditions above are straightforward and usually relatively easy to meet, the fourth (commercial business) can pose challenges, especially if the company whose shares are being sold is engaged in the real estate business. The Ministry of Finance's guidelines indicate that, for purposes of the participation exemption, a company is not engaged in a commercial business if more than 50 percent of the value of its assets comprises real estate held for investment or rental purposes. As a result, "passive" real estate companies, or real estate companies engaged in the mere holding or rental of real estate properties, will generally not qualify

for the participation exemption. Exceptions apply for qualified leasing transactions. Real estate companies engaged in construction or sale of real estate properties will generally qualify for the participation exemption.

Passive real estate companies, and other companies that would otherwise not qualify for the participation, should consider taking part in corporate reorganizations involving the reshuffling of assets among group companies so their shareholders may qualify for the participation exemption. The guidelines provide several examples of corporate reorganizations and their effects on the conditions required to benefit from the participation exemption.

Shares of Holding Companies

For dispositions of shares of holding companies, the law provides special look-through provisions that apply for purposes of verifying whether the

third condition (tax havens) and fourth condition (commercial business) are met.

Those look-through provisions indicate that the conditions must be met not by the holding company itself, but by the companies whose shares are owned, directly or indirectly, by the holding company and whose value represents more than 50 percent of the holding company's value.

The guidelines provide practical examples that describe the application of the look-through provisions.

Conclusion

Italian corporations and Italian permanent establishments planning to dispose of their investments in other companies should review whether those dispositions qualify for the participation exemption. The exemption will generally not apply to dispositions of shares of passive real estate companies; however, some corporate reorganizations discussed in the guidelines may be helpful in satisfying one or more conditions required to qualify for the participation exemption. ♦