Debt and equity financing: the Italian rules

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1. Introduction.

The issue concerning the tax neutrality among the ways available to finance a business (*i.e.* the use of debt financing instead of equity financing) is well known to the Italian legislator that, as better described in the following paragraphs, has more than once regulated the matter, albeit without finding a fully satisfactory solution.

Based on economic literature[2], a neutral, correct and efficient system is that under which interest expenses (*i.e.* the debt financing cost) are deductible for tax purposes in the hands of the company paying it and taxable for individual income tax purposes in the hands of the recipient, whilst profits (*i.e.* equity financing cost) are taxable in the hands of the entity paying them, however such taxation qualifies only as a form of advance payment of the personal income tax due by the shareholder on dividends (the distribution of which is not deductible for the company paying them). Such a system provides for a uniform tax treatment applicable to interest and dividends, limiting the possible distortions in the choice of financing mechanisms available for a business to the sole different tax treatment applicable to retained profits, which are subject to the sole corporate income tax until they are distributed to the shareholders.

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[2] S. Giannini, *Gli interessi passivi nel quadro della tassazione societaria internazionale*, in *Dial. trib.*, 2008, p. 14.

Italy[3] differs from such benchmark[4].

Interest expenses, deductible for tax purposes in the hands of the company, are subject to taxation through final withholdings at 20%[5]; profits, which are not deductible for tax purposes in the hands of the company, are either partially taxable in the hands of the recipient or subject to a substitutive taxation regime so that their "aggregate" taxation (*i.e.* taxation in the hands of both the company and the shareholder) now ranges between 35,8% and 43%. The above regime favours the use of debt financing and thus the Italian legislator sets out from time to time different rules aimed at limiting the thin capitalization of companies.

It can be immediately seen that the main action taken by the legislator in order to fight the thin capitalization is that of limiting and conditioning the deductibility of interest expense for corporate taxpayers. Conversely, the tax treatment of recipients of the interest payments has not been amended in any material way. The tax treatment of both dividends and interest in the hands of their recipients (especially if individuals) follows its own rules that aim at guaranteeing the tax neutrality among corporate financing mechanisms, although in a rather indirect manner.

This paper shall first examine the provisions enacted by the Italian legislator in order to contrast the thin capitalization of corporate entities and then the provisions governing the tax treatment of dividends and interest in the hands of their recipient. Please note that their analysis gives the impression

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[3] In brief it is recalled that, as far as it may be of interest for the present purposes, resident companies and commercial entities are subject to a proportional tax levied at 27,5% on the worldwide income and named Corporate Income Tax (IRES). Resident individuals are subject to a proportional and sliding scale personal income tax (IRPEF) levied on their worldwide income levied at 23% (for income up to 15.000 euro), at 27% (above 15.000 euro and up to 28.000 euro), at 38% (above 28.000 euro and up to 55.000 euro), at 41% (above 55.000 euro and up to 75.000 euro), at 43% (above 75.000 euro). Moreover, economic (corporate and self-employment) activities are subject to a Regional Tax on Productive Activities (IRAP) levied at a base rate of 3,9% on a wide taxable basis (including personnel expenses and interest expenses).

[4] S. Giannini, *Gli interessi passivi nel quadro della tassazione societaria internazionale*, quot., p. 15.

[5] Such tax rate is that resulting after the amendments to the tax system made by the Law Decree no. 138 of 13 August 2011, converted into Law no. 148 of 14 September 2011. Such amendments replaced the existing tax rates applicable on income from capital and on capital gains having a financial nature of either 12.5% or 27% with a flat tax rate levied at 20%. Such flat rate applies on interest, premiums and any other proceed amounting to income from capital, as well as on capital gains respectively becoming due or realized after 1st January 2012; the flat rate applies to dividends and proceeds of a similar nature received after 1st January 2012, irrespective of the date in which the distribution was resolved.

that the Italian tax system is not neutral and leaves great possibilities of tax arbitrage between debt or equity financing. As described in the following paragraphs, the use of debt financing rather than contributions in cash is far more tax effective for taxpayers.

2. The tax deductibility of interest expense in business income.

As already highlighted, the basic guideline followed by the Italian legislator in order to reach a balance between the tax treatment of debt financing and that of equity financing is that of limiting, either totally or at given conditions, the reduction of interest expense for tax purposes. Such position (or rather, such different positions adopted from time to time) affected the amount of interest expenses which could be deducted, instead of affecting the deduction right itself.

Under such perspective, indeed, the theoretical issue that arose (and which was positively solved) is whether interest expense deductibility in business income must first be examined in the light of the general principles governing such category of income. Also such item of income should, indeed, be subject to the criteria set out by art. 109 of the Income Tax Act (hereinafter "ITA"), *i.e.* to (i) the accrual principle (taxation of interest in the year in which it accrued), (ii) the prior accounting in the P&L and to (iii) the inherence principle (inherence of interest expense to the business carried out)[6].

Whilst the applicability of the first two principles (accrual and prior accounting in the P&L) is certain, doubts exists as to the applicability of the inherence principle[7]. The Supreme Court, which examined the matter more

[6] L. ROSA., *Il principio di inerenza*, in *Il reddito di impresa*, G. Tabet (ed.), Padua, 1997, p. 138.

[7] It is renown that such principle must be interpreted as granting relevance, for the purposes of determining the business income, to costs that are connected with the activity carried out by the entrepreneur or by the company. Also case law confirmed this interpretation, please see: Supreme Court decision no. 10257 of 21 April 2008; Supreme Court decision no. 16824 of 30 July 2007; Supreme Court decision no. 22034 of 13 October 2006; Supreme Court decision no. 19610 of 13 September 2006).

than once[8], reached contrasting conclusions. In some decisions it stated the non applicability of such principle[9], whilst in others[10], which are the majority, it deemed that art. 109 ITA excludes interest expenses only from the need of checking their direct relation with profits, but not also in relation to the business activity[11]. Such a legislative choice would be aimed at avoiding discussions on the use of the principal giving rise to the interest expenses, but does not require to meet the inherence requirement which is to be checked on a case by case basis.

After addressing the matter of whether interest expenses were deductible within business income, the legislator addressed the matter of the amount of deductible interest expenses, having regard to a general interest in limiting the use by enterprises of debt financing without aiming at

[8] The doubt about its applicability to interest expense arises from the different wording of art. 61 ITA, regulating business income realized by taxpayers subject to individual income tax, and of art. 109 ITA, regulating business income realized by taxpayers subject to corporate income tax. Indeed, whilst on one hand art. 61 conditions their deductibility to the inherence test, on the other hand art. 109 does not make any reference to such requirement.

[9] Please see *ex multis,* Supreme Court decision no. 14702 of 21 November 2001, where it stated that in the framework of business income, the right to deduct interest expense for tax purposes must always be granted without taking care of their inherence to the business activity, so that art. 109, para. 5, ITA must be interpreted in the sense of allowing in any case their deductibility, irrespective of any evaluation on the right to deduct or on the amount being deductible. In particular, following the provisions of art. 61 ITA, the Supreme Court stated that, since such provision sets out that interest expenses are deductible for the portion corresponding to the ratio between (i) revenues and other profits living rise to taxable income and (ii) the overall amount of revenues and other profits, such provision "*does not set out any limit for the deductibility of interest expense in relation to the event to which they are linked or to the nature of the principle giving rise to them, since the calculation method therein indicated works irrespective of any analysis of the nexus between the interest expense and the activity carried out by the enterprise as it instead occurs with respect to the other negative items of income*" (Supreme Court decision no. 12990 of 4 June 2007). Under this perspective, the right to deduct interest expenses would not be linked to the inherence principle which, conversely, continue to apply to expenses and other negative items of income (save for tax, social contribution and public utility burdens); this reasoning would be based on "*a logic aimed at simplifying the tax assessment method of taxable income which, at the same time, does not jeopardize the tax authorities interest to tax as much as possible all taxable income*" (Supreme Court decision no. 2114 of 2 February 2005).

[10] Supreme Court decision no. 7292 of 29 March 2006.

[11] More in detail, such an analysis shall be carried out in the sense of verifying the inherence to the business activity not of interest expense as such, but of the principal giving rise to the interest. According to the position expressed by such case law, shared also by literature (G. Tinelli, *Art. 109 (Norme generali sui componenti del reddito di impresa)*, in *Commentario al Testo Unico delle Imposte sui Redditi*, by G. Tinelli, Padua, 2009, p. 995; R. Lupi, *Limiti alla deduzione degli interessi e concetto generale di inerenza*, in *Corr. trib.*, 2008, p. 773), the ITA legislator, despite the applicability of the inherence principle to interest expenses, would have excluded them from the applicability of the principle according to which an expense is deductible if linked to a taxable income: indeed it would have deemed necessary to set out a specific regime prevailing on other tax rules.

increasing the use of venture capital (equity). Such approach implied the amendment of the general provisions on the deductibility of interest expenses and, just in some occasions, also led to the adoption of policies aimed at discouraging thin capitalization behaviours (*thin capitalization rule*) and favouring, although just indirectly, the use of venture capital (*dual income tax*).

Before delving into the analysis of such legislative amendments, it can be highlighted that they were not neutral. Although different from one another, they were similar in the sense that both did not aim at pursuing the neutrality of the tax system. A first criticism to be highlighted is that of having implemented throughout the years a policy exclusively aimed at solving the current issues from time to time existing, without offering an overall solution for the tax system here under scrutiny.

2.1. The former rule under art. 63 ITA.

The original wording of art. 63 ITA stated that "*interest expenses are deductible for the part corresponding to the ratio between the amount of revenues and other profits that give rise to taxable income and the overall amount of revenues and profits*"[12]. Such rule had a twofold purpose: to exclude interest expense from the application of the criteria setting out either (i) the full deductibility of items related to activities giving rise to revenues or other taxable income or (ii) the full non deductibility for tax purposes whenever they were related to exempt activities.

This meant that interest expense ratio of deductibility has to be proportionally determined both in case such expenses were attributable to taxable (or excluded from taxation) items of income and in case they were attributable to exempt items of income. As clarified also by the Italian Tax

[12] For the purposes of applying art. 63 ITA, the following formula applied: A : B = X : 100 in which A meant the amount of revenues and other profits giving rise to taxable income and B meant the overall amount of revenues and other profits including those tax exempt, and X the percentage of deductible interest expenses. Please see L. Del Federico, *Interessi passivi*, in *Giurisprudenza sistematica di diritto tributario – L'imposta sul reddito delle persone fisiche*, F. TESAURO (ed.), II, Turin, 1994, p. 708.

Authorities[13], such a choice was justified by the natural impossibility to link interest expenses to a specific item of income since money (obtained under a loan arrangement) is a fungible asset.

The legislator, in the light of simplification, preferred to resort to a comprehensive criterion, sometimes useful to the Tax Authorities, sometimes to the taxpayer, which was already extensively tested: for the purposes of movable wealth category B[14], art. 23 of Law no. 1 of 5 January 1956 already provided for the deductibility of interest expenses for a portion corresponding to the ratio between (i) the amount of gross revenues that gave rise to income from movable wealth and (ii) the aggregate amount of all gross revenues of the taxpayer. Such provision was then transposed in art. 110 of Law No. 645 of 29 January 1958 (the "consolidated law on income taxes")[15].

Such provision was criticized since it was not neutral when it came to corporate entities decisions on investment and financial matters[16]: jointly with the rules on taxation of income from capital, delved into in the following paragraphs, which provided for a different tax treatment of income from capital based on whether the financing occurred through debt or equity, said provision favoured the option to finance corporate entities through debt. Indeed, only debt financing allowed for the tax deduction of its intrinsic cost, *i.e.* of interest expense, from corporate entities taxable income, whilst equity financing did not grant any corresponding advantage.

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[13] Ministry of Finance – Income Taxation, Circular no. 3 dated 2 February 1976; Ministry of Finance – Income Taxation, Circular no. 4 dated 18 February 1986.

[14] It concerned a tax that was levied on commercial entities corporate income.

[15] F. Napolitano, *Interessi passivi*, in Commentario al Testo Unico delle imposte sui redditi ed altri scritti, Rome – Milan, 1990, p. 350.

[16] F. Gallo, *La tassazione dei redditi d'impresa: i difetti e le proposte di modifica*, in *Rass. trib.*, 1997, p. 121.

2.2. The current rule on the deductibility of interest expense.

2.2.1. Description of the current rule.

A similar approach, *i.e.* limiting the amount of deductible interest expenses irrespective of ulterior motives, was adopted by the legislator with Budget Law for 2008 (law no. 244 of 24 December 2007), which introduced the current applicable rule[17].

Such law amended art. 96 (former art. 63) ITA granting to corporate income taxpayers, in each tax year, the full deductibility of interest expenses and similar charges up to the amount of interest income and similar income[18]. Interest expenses possibly exceeding the interest income of the year may be deducted for tax purposes in the limit of 30% of the yearly EBITDA, to be determined by the difference between the production value and costs, excluding depreciations of tangible and intangible assets and of the rents paid for assets under financial lease[19].

Interest expenses and similar financial burdens that can not be deducted in the tax year, since they exceed the above threshold, can be carried forward

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[17] On this topic M. Leo, *Le imposte sui redditi nel Testo Unico*, Milan, 2010, p. 1692.

[18] Art. 96. para. 1, ITA expressly excludes from its scope of application interest expenses and similar charges included in the cost of goods pursuant to art. 10, para. 1, lett. *b)*, ITA. The deductibility rules set forth by art. 96 ITA will apply to interest whether or not included in the cost of the goods.

Pursuant to art. 96, para. 3 ITA, attention shall be paid not only to interest incomes and expenses originated by contractual relationships having a financial aim (loan, lease, issuance of bonds and similar securities, notional cash pooling). Therefore, the relevant interest (incomes and expenses) for such purposes do not include both delayed interest payments and interest payments due for the omitted payment of taxes, since they both do not have a voluntary financial aim.

Pursuant to a specific provision, implicit interest arising from commercial debts do not fall within the determination of interest expenses, whilst interest income arising from the same source fall within the determination of interest income. It is possible to determine also virtual interest income due for delayed payments by the public administration and they are determined at the official discount rate plus one base point.

[19] The EBITDA is defined by art. 96, para. 2, ITA as the difference between the value and costs of productions (as per letters A) and B) of art. 2425, of the Italian civil code) as resulting from the profit and loss account, with the exclusion of the following negative items of income:

1) depreciation of tangible and intangibles assets listed in lett. B), n. 10), points a) and b), of the profit and loss account;

2) assets lease rents included in lett. B), n. 8), of the profit and loss account.

In its determination reference shall be only made to the accounting data *"as resulting from the yearly profit and loss account"*; and for entities drafting the accounts pursuant to IAS/IFRS, the determination of the relevant amount is made *"pursuant to the corresponding items of the profit and loss account".*

without time limits[20], and deducted in subsequent tax years up to the amount of the EBITDA available in that year, *i.e.* of the amount of EBITDA possibly exceeding[21] that already used to deduct the interest expense exceeding interest income of the relevant year.

2.2.2. The scope of application.

Such rule applies only to corporate income taxpayers, albeit with the exclusion of certain categories of enterprises. Since its original version, the provision has, indeed, excluded from its scope of application banks and other financial entities mentioned in art. 1 of Legislative Decree No. 87 of 27 January 1992 (SGR, SIM, financial intermediaries, SICAV, etc.), insurance companies as well as holding companies of banking and insurance groups since such groups of taxpayers had different characteristics to be separately addressed[22]. This exclusion comes from the main importance of debt for these companies, in relation to which the fund-raising activities imply, as an ordinary burden, the payment of interest and similar charges. As a consequence, they had initially been allowed to deduct interest expenses without any limitation. However, they were then subjected to a different and independent limit to such deduction right. Indeed, art. 96, para. 5-*bis* ITA now states that the interest expenses are deducted from the corporate income tax base of these entities within 96% of their amount. This way, also banking, insurance and financial companies are now subject

[20] Art. 96, para. 4, ITA, regulates the case in which the exceeding interest expenses exceed the available EBITDA (given by the sum of 30% of the EBITDA of the year plus the amount of previous EBITDA not yet utilized). In this case, the excess of interest expenses may be deducted in the following years without any time limit whenever in such years the conditions for their deductibility are met. The use of interest expenses is however conditional to the fact that in such subsequent years the amount of interest expenses and of similar charges is lower than 30% of the relevant year EBITDA.

[21] Art. 96, para. 1, ITA allows to increase the 30% of the EBITDA of the subsequent tax year with the part of (the 30% of the) EBITDA, if any, not used in the given year, since it exceeded the amount interest expenses. The EBITDA excess shall be used to offset interest expenses during the first tax year in which interest expenses shall exceed the amount of interest income (and shall also exceed that year 30% of the EBITDA).

[22] V. Bassi, *Art. 96 (Interessi passivi)*, in *Commentario al Testo Unico delle Imposte sui Redditi*, G. Tinelli (ed.), Padua, 2009, p. 830.

to a tax deductibility regime for interest expenses in line with that set out by art. 96, para. 1 ITA for any other corporate income tax taxpayer[23].

The system currently applicable is therefore twofold: on the one hand, specific rules are provided for all operating companies, whilst on the other hand financial companies are subject to their own specific rule.

2.2.3. The interest expense deductibility for individual.

Also the rules applicable on the deductibility of interest expense for taxpayers subject to personal income tax (sole traders and partnerships) were repealed and the former art. 61 ITA consistently amended as to provide for a single scheme setting out a limited deduction right for interest expense based on the relationship between (i) the amount of revenues and other items falling within the tax base (or not falling within it as they are excluded) and (ii) the total amount of revenues and incomes. It partially recalls the similar provision included in art. 109, para. 5 ITA, although it neglects introducing a provision similar to that contained in its final period and according to which "*capital gains falling within art. 87 ITA are not relevant to the application of the preceding period*". It follows that for individual income tax subjects, capital gains that may benefit from the participation exemption regime and taxable limitedly to 49.72% of their amount only shall be included in the formula above described.

The decision to differentiate the regime on the deduction of interest expenses on the basis of the nature of the taxable person arises, as stated in the explanatory memorandum to the draft Budget Law for 2008, from the opportunity to set out a more favourable tax regime for individual income

[23] A specific regime was set out also for the case in which such companies opted for the tax consolidation regime: the deduction of interest expenses accrued between companies part of the tax consolidation regime (so-called intergroup interest expenses) up to the amount of interest expenses accrued by the same companies towards third parties (*i.e.* lenders not part of the consolidation regime).

tax subjects, who did not benefit from the tax rate reduction set forth by the Budget Law for 2008[24].

2.2.4. Special rules applicable to groups.

The current version of art. 96 ITA is not exempt from criticism. Both dividends and capital gains on participations are not taken into account in order to determine the EBITDA. This approach penalizes industrial holdings engaged, either exclusively or primarily, in the business of holding capital stock in companies engaged in activities other than credit or financial ones and that, therefore, generally earn only financial income[25]. For these companies, the current method sets out to determine the EBITDA does not appear to be in line with the main purpose of art. 96 ITA, which is stated to be that of identifying a reasonable ratio between the costs arising from debt financing and the amount of the income arising from core activities of the company. The only limitation to such scheme is provided for by art. 96, para. 7, ITA where it is set forth that, in the case of participation in the domestic tax consolidation regime, "*any excess of interest expense and*

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[24] In any case, the existence of two different tax deduction regimes, a stricter one for entities subject to corporate income tax and one more favourable for enterprises subject to individual income taxation (partnerships), required the introduction of further provisions aimed at preventing tax avoidance by stock companies that tried to have all interest expenses borne by their controlled partnerships, as to avoid the application of the corporate income tax regime on such interest expenses and allow their deduction for tax purposes in the form of losses allocated on a pass-through basis on the holding company by the controlled enterprises. Para. 6 of art. 101 ITA sets out that the losses allocated on a pass-through basis by partnerships are no longer available for deduction against the income of resident stock companies and commercial entities, indeed they can only be used to offset profits allocated in the subsequent five years on said latter entities by the same entity giving rise to the loss. The above rule implies that the position of the controller company, bearing losses due to its interest expenses, is substantially equal to that of the holding company in case it directly borne the interest expenses. The same rule applies also to non resident companies and commercial entities, without a permanent establishment in Italy, investing in Italian partnerships. Conversely, when an individual entrepreneur or a partnership owns participations in a commercial partnership, pursuant to art. 56, para. 2, ITA, the losses of the commercial partnership may be fully offset with the income of the individual entrepreneur or a partnership. In such cases, no anti-avoidance mechanism needs to be implemented since individual entrepreneurs and partnerships deduct interest expenses from their business income according to the same rules, so that, as highlighted in the report to the provision, "*in such the avoidance that required the amendment of para. 6 of art. 101 cannot occur*".

[25] See G. Escalar, *Gli oneri finanziari soggetti ai nuovi limiti di deducibilità dall'imponibile IRES ed IRAP*, in *Corr. trib.*, 2009, p. 1664.

similar charges arising in the hands of a participant to the consolidation regime may be used to reduce the overall income of the group if and to the extent that other participants to the consolidation regime register, for the same tax period, an EBITDA not fully exploited for the purposes of deducting interest expenses".

The above provision is completed by paragraph 8 of the same art. 96 ITA, according to which "*for the sole purposes of the application of para. 7, the participants to the domestic tax consolidation regime shall virtually include also foreign companies meeting the requirements and conditions*" necessary to opt for the tax consolidation regime. The reason behind this rule, which allows the virtual inclusion of foreign companies, and behind the consequent possibility of using these companies available EBITDA for the purposes of calculating the amount of deductible interest expense, is that of not discriminating industrial holding companies owning interest in foreign subsidiaries when compared to holding companies owning interest in domestic subsidiaries. Therefore, in the virtual tax consolidation regime, the legislator shares the principle that interest expenses arising in Italy can be absorbed and deducted on the basis of an EBITDA arising abroad. The EBITDA of foreign subsidiaries is taken into account, consistently with the rules set out for residents, net of interest expenses and similar charges that the relevant subsidiary bears.

2.3. Policies adopted by the Italian legislator against the thin capitalization of enterprises.

The current deductibility regime for interest expenses pursues, in a fully indirect way, a policy against the thin capitalization of companies; in the past, instead, as mentioned, such aim was pursued through specific actions taken by the legislator.

Reference is made to the thin capitalization rule and to the dual income tax which tried to follow a more advanced tax policy: the first with a punitive approach and the second with a rewarding one which was also aimed at favouring the use of venture capital.

2.3.1. The *thin capitalization rule.*

The provisions examined, the former art. 63 ITA and the current art. 96 ITA, represent the weaker mechanisms through which the legislator tried to direct the entrepreneurial choices as to the thin capitalization of companies. Such issue is faced only indirectly and in an imprecise manner; the rules examined, indeed, do not distinguish between the different kinds of behaviours adopted by taxpayers and do not even try to direct the entrepreneurial choices. They apply in a generic way and hit without any distinction any form of either physiological or pathological debt.

Conversely, through the thin capitalization rule applied between 2004 and 2008 the legislator tried to adopt a more structured policy.

The opportunity to amend the DIT regime occurred upon enacting the so-called Corporate Income Tax Reform through which the approach to the taxation of interest was once more changed: (repealed the DIT which will be discussed shortly) articles 96, 97 and 98 ITA have been introduced. Said provisions, becoming applicable in reverse order (*i.e.* starting with art. 98 ITA back to art. 96 ITA), are based on a totally different approach. In particular, whilst the thin capitalization rule (art. 98 ITA) pursued the aim of contrasting the thin capitalization of business activities, the provisions set out by articles 96 and 97 ITA were aimed at coordinating with other amendments introduced by the Corporate Income Tax Reform.

Art. 97 ITA (*pro rata patrimoniale*) was intended to prevent the deductibility of that part of interest expenses remunerating loans obtained to finance the acquisition of participations that, if transferred, would enjoy the newly introduced tax exemption regime (so-called participation exemption regime) set forth by art. 87 ITA. Such provision overcomes the comments made above in relation to the non applicability to interest expense of the general rule set out by art. 109, paragraph 5, ITA. It represented a technical mechanism designed to determine the lump sum amount of non-deductible interest expenses in principle attributable to exempt capital gains.

The rule set out by art. 96 ITA (*pro-rata generale*) formally replaced the rule prior governed by the above mentioned former art. 63 ITA. However, although preserving the basics of said provision, it adapted it to the 95% exemption regime applicable on dividends.

The above described amendments can be defined as mere "maintenance" of the tax system in force before the Corporate Income Tax Reform and aimed at its update in the framework of the new rules set forth by the legislator as to tax exemptions and partial exclusion from taxation of certain items of income.

On the contrary, the art. 98 ITA represented a complete novelty[26]. Under an operative perspective, it sets out the non-deductibility of interest expense related to loans granted and/or secured by qualified shareholders[27] and/or by its related parties[28], regardless of their residence[29], whenever the total amount of loans granted and/or secured[30] by said qualified shareholders

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[26] On this topic S. La Rosa, *La capitalizzazione sottile*, in *La riforma del regime fiscale delle imprese: lo stato di attuazione e le prime esperienze concrete*, F. Paparella (ed.), Milan, 2006, p. 91; L. Del Federico, *La thin capitalization*, in *Imposta sul reddito delle società (IRES),* F. TESAURO (ed.), Bologna, 2007, p. 493; M. Beghin, *La thin capitalization*, in *L'I.Re.S. due anni dopo: considerazioni, critiche e proposte – libro bianco*, a cura di A.N.T.I., Associazione nazionale tributaristi italiani, Milan, 2005, p. 79.

[27] A "qualified" shareholder meant a shareholder who:
- controls directly or indirectly the borrower company pursuant to art. 2359 of the Italian Civil Code;
- directly or indirectly holds at least 25% of the borrower's company share capital.

[28] "Parties related to the qualified shareholder" meant companies controlled pursuant to art. 2359 of the Italian Civil Code by said qualified shareholder and, in case of individual shareholders also the spouse and relatives within the third degree and quasi-relatives up to second degree.

[29] The Italian legislation on the thin capitalization rule had, on the European scene, a very wide scope because, differently from similar provisions applied in other EU countries, in order to take into the due account the statements of the European Court of Justice, it applied regardless of the place of residence of shareholders. Reference is made to the decision dated 12 December 2002 on Case C-324/00, *Lankhorst-Hohorst GmbH v/ Finanzamt Steinfurt* and the decision dated 18 September 2003 on Case C-168/01, *Bosal*, in which the Court expressed a principle of law according to which conditioning the enforcement of anti-thin capitalization rules to the fact that the interest expenses deducted are taxed in the same country is in breach of EU law. On this topic A. Comelli, *Sul contrasto all'utilizzo fiscale della sottocapitalizzazione*, in *Dir. prat. trib.*, 2004, p. 249; A. Contrino, *La normativa fiscale di contrasto della "thin capitalization"*, in *Dir. prat. trib.*, 2005, p. 1235.

[30] The facilities relevant for the application of the thin capitalization rule were "those arising from loans, deposits of money and any other relationship having a financial nature". Instead, secured facilities were loans secured by collateral, whether real, personal or de facto (*i.e.* provided through legal acts or behaviours that did not qualify as a formal release of security but that, in terms of economic substance, achieved the same results).

and/or by their related parties exceeds by at least 4 times the overall share of net assets attributable to said shareholders or to their related parties.

The thin capitalization rule was not applicable only when the borrower (*i.e.* taxpayer owing the interest) could prove that the loans granted or secured by the qualified shareholders were justified on the basis of the borrower's own debt capacity and thus the loans would also have been granted by a third party with the only independent guarantee of the borrower's assets.

The thin capitalization rule shall be mentioned, with respect to the previous amendments, since it better identified the behaviours to be deemed as pathological: facilities granted or guaranteed by qualified shareholders provided that certain (subjective and objective) requirements are met and re-qualifying the sums paid to the shareholders as profits.

The above implied that the thin capitalization rule had an anti-avoidance nature[31], irrespective of the principles set out in the ministerial report to legislative decree no. 344 of 12 December 2003, according to which "*the thin capitalization rule is aimed at fighting the tax use of thin capitalization … as well as at favouring the use of equity financing, to the advantage of the entire tax system competition*"[32].

Indeed, it did not amount to a provision aimed at balancing the cost of debt financing with that of equity financing, the difference of which had increased after the repeal of the DIT. In its role of balance rule it was indeed too limited since it did not concern debt financing in general (including third parties financing). Moreover, it applied on a discontinuous basis, and only

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[31] Along the same guidelines the legislator implemented a reform of company law through legislative decree no. 6 of 17 January 2003. The reform, through art. 2467 of the Italian Civil Code, introduced for limited liability companies some detrimental regimes for shareholders' loans. The first paragraph sets out that the refund of shareholders' loan shall occur only after the repayment all other corporate creditors and that in case the repayment of the shareholders' loan occurs during the year preceding the bankruptcy of the company, the relevant amount shall be returned to the company. Through such provision, shareholders' loan are assimilated to equity contributions, so that the management body providing for their repayment must pay attention in order not to jeopardise the rights of other creditors and thus performs an unlawful repayment. The second paragraph, moreover, sets out that for the purposes of the first paragraph loans granted in any form at a time when the debt-to-equity ratio is not well balanced, also considering the kind of activity carried out by the company, or when an equity contribution would have better fit the financial position of the company, are assimilated as shareholders' loans without any possibility of demonstrating the opposite.

[32] R. Lupi, *Prime osservazioni in tema di Thin Capitalization*, in *Rass. trib.*, 2003, p. 1493; D. Stevanato, *Indeducibilità degli interessi passivi e "genuinità" del finanziamento: istanza di disapplicazione preclusa?*, in *Corr. trib.*, 2008, p. 2694.

above a threshold of the debt-to-equity ratio which was particularly high, even if compared at an international level. The assimilation of the interest expenses to dividends, which it set out, could then produce cases of economic double taxation in international relationships and the discrimination of minority shareholders which did not qualify as lenders of the company.

The structuring of the thin capitalization rule as an anti-avoidance aim, rather than as a ordinary rule (due to an inappropriate choice of the legislator as to the thresholds set out for the application of this rule and as to the debt-to-equity ratio chosen), made the rule unsuitable to pursue a policy of fiscal neutrality in the choice of business financing.

The above criticism, jointly with other[33], implied that also this approach to the matter could not be deemed the final one by the legislator, which through art. 1, para. 33, lett. l), of Law no. 244 of 24 December 2007 (so-called Budget Law for 2008), as already pointed out, has further amended the mentioned provisions.

2.3.2. The *Dual income tax.*

The most relevant action against the thin capitalization of companies was pursued by the legislator through Legislative Decree no. 466 of 18 December 1997, the so-called "*Dual Income Tax*" (DIT).

Under a tax perspective, the DIT did not distinguish among the various forms of business financing since it extended the advantages of debt financing also to equity financing, eliminating any discrimination between the regime applicable to debt and equity[34].

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[33] The provision at stake referred to a limited number of enterprises since it did not apply to all companies subject to the so-called "*studi di settore*" nor to those part of a tax consolidation regime. Moreover, the "self-credit ability" was particularly hard to prove. Furthermore, the rule was asystematic: it went beyond its original nature, after the amendments introduced by the decision *Lankhorst-Hohorst GmbH* (case C-324/00), which forbids to limit its application to non resident shareholders' loans.

[34] F. Pistolesi, *La "Dual Income Tax" - Commento al decreto legislativo 18 dicembre 1997, n. 466*, in *Dir. prat. trib.*, 1998. p. 701.

The DIT was based on the assumption of dividing business income into two components to subject to a different tax regime: (i) a first one represented by the corporate capital subscribed by shareholders and kept at a company level and (ii) a second one defined as the difference between business profits (net of interest expenses) and business income sub (i).

Until the introduction of DIT such items of income were subject to taxation at the same rate, whilst under the DIT regime they become subject to a different tax rate.

In a nutshell, pursuant to the DIT it was set out that the taxable income should be divided into two parts: a first one subject to a reduced tax rate of 19% and a second one subject to the then ordinary tax rate of 37%, provided that the overall tax burden was not, according to the original version of the provision[35], on average, lower than 27%[36]. For the purposes of the application of the DIT, it was therefore necessary to determine the following items: (a) the "*upward adjustment of the equity invested with respect to that existing at the close of the year running on 30 September 1996*"[37]; (b) the "*coefficient of ordinary remuneration*" (the so-called CRO)[38].

Through this taxation mechanism the legislator addressed the issue of the neutrality of the forms of business financing by way of adopting a logic of rewards: the behaviours held by taxpayers and deemed to be virtuous (*i.e.* the use of equity rather than debt financing) were favoured by a reduced

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[35] Paragraph 1 of art. 1 of Legislative Decree no. 466 of 1997 was later amended to provide for the application of the DIT mechanism according to a multiplier of the principal invested. The result was a strengthening of the DIT mechanism (renamed Super DIT), in order to anticipate the upward adjustment of the value of principal invested up to value of net worth resulting from the accounts, which remained the maximum limit for the subsidy. This improvement was achieved providing that the upward adjustment of the principal invested, calculated as described above, would be increased by 20% for the year following that in progress at 30 September 1999, and by 40% for subsequent years.

[36] On technical aspects G. Ricotti, *Potenzialità effettive della Dit quale strumento di riduzione della pressione tributaria*, in *Rass. trib.*, 2000, p. 487.

[37] The capital invested at the end of financial year in progress at 30 September 1996 was represented by the net worth resulting from the relevant accounts, without considering year 1996 profits. The upward adjustment of such net worth was calculated as the um of increases and decreases of the net worth arising from facts independent of the enterprise will.

[38] The coefficient of ordinary return of the net worth increase was determined each year by the Minister of Finance, in consultation with the Minister of Treasury, taking into account the average financial returns on government bonds, which could be increased up to 3% to cover the higher risk.

tax burden which arose from the reduction of the applicable tax rate. Therefore, the DIT system, although regulated outside the ITA, directly impacted on the amount of tax payable by subjects carrying on a business activities. Such system mitigated the effects of the then applicable art. 63 ITA through the application of a lower tax rate[39].

2.3.2.1. The combined applicability of DIT and IRAP.

The effects of the DIT may not be fully appreciated without taking into account its operation in conjunction with the Regional Tax on Productive Activities (IRAP) regulated by Legislative Decree no. 446 of 15 December 1997, the aim of which was precisely that of promoting the capitalization of domestic productive activities.

It is noted that IRAP, in so far as it is relevant for the purposes of this discussion, is levied on the net value of production of enterprises, so that it necessarily includes in its tax base the remuneration of production elements, which include, besides profits, salaries and interest expense. Under a technical perspective such goal is achieved by art. 5 of Legislative Decree no. 446 of 1997 which provides that the tax base of commercial companies is calculated starting from on the total items of income generated by the typical and ordinary business activity and subtracting from such amount the costs of production other than those that remunerate external funding and third party work (*i.e.* interest expenses and salaries).

The above method of determining the tax base means that IRAP system disadvantages the use of indebtedness and, symmetrically, favour a greater use of self-financing and venture capital. Therefore, the DIT and IRAP were supposed to closely interact among each other:

[39] The contrast to use of debt financing by companies was then completed with art. 7, Law Decree no. 32 of 20 June 1996, converted with amendments into Law no. 425 of 8 August 1996, which provided for a withholding at source levied at 20% on income attributable to triangular transactions involving the deposit by a non-entrepreneur of money, securities and other securities other than shares (and similar securities) as collateral of loans granted by banks to enterprises.

- IRAP by way of strengthening the effects of the DIT on the choices concerning financial structures and of further narrowing the gap in the tax treatment of equity and debt financing;
- the DIT by way of ensuring significant tax reductions to companies reinvesting funds in the business or injecting equity to get out of low profitability and high indebtedness situations.

In general, IRAP and the DIT should have resulted as an immediate incentive to use self-financing, thus providing a double benefit to the taxpayer (as opposed to an alternative use of debt financing) in terms of a greater amount of after tax income (although IRAP tax base would be unchanged)[40].

2.4. The Italian legislator's underlying goals.

The Italian legislator policy on interest expenses and contrast to the thin capitalization resulted to be rather differentiated and various approaches have been taken during the years.

The DIT, operating jointly with IRAP, certainly represented the measure through which the legislator more efficiently tried to fight the thin capitalization of companies. The DIT and IRAP, irrespective of the right to deduct interest expenses as an item giving rise to business income, tried to direct the choices of entrepreneurs towards physiological forms of financing.

The *thin capitalization rule* fully amended such approach: whilst the DIT favoured the use of venture capital and IRAP discouraged the use of debt financing, the thin capitalization rule was active only in one direction. It solely discouraged the use of debt financing, which added to the discouragement under IRAP[41].

[40] R. Lupi, *L'Irap tra giustificazioni costituzionali e problemi applicativi*, in *Rass. trib.*, 1997, p. 1407; M. Iavagnilio, F. Trutalli, *Irap e dual income tax. Un approccio indiretto alla thin capitalization. Effetti della riforma fiscale sulle scelte di finanziamento delle imprese multinazionali*, in *Il Fisco*, 1998, p. 5038.

[41] G. D'Abruzzo, *Il contrasto all'utilizzo fiscale della sottocapitalizzazione nel Tuir riformato. Analisi delle scelte legislative ed inquadramento sistematico*, in *Rass. trib.*, 2004, p. 828.

As compared to the DIT, the *thin capitalization rule* addressed in a better way all the subjects involved. Indeed, whilst the DIT addressed the problem approaching it solely from the perspective of the borrower, the thin capitalization rule proved to further reduce the interest in using debt financing since it addressed the issue from both the borrower and the lender's perspectives, providing for the requalification of interest payments as profit distributions.

The current system differs from the former ones since it significantly simplified the tax deduction regime, grounding the assessment of the adequacy of the debt's level and, consequently, the deduction of interest expenses from the business income on a criterion (the EBITDA) which is not linked to the taxpayers dimensions or to the holding of stock eligible for the participation exemption regime.

The aim of the new approach is that of favouring the capitalization of companies without affecting in an irreversible way those characterized by thin capitalization financial structure and without affecting the owners of participations recorded as financial assets benefitting from the participation exemption regime or in any case the owners of exempt income.

Moreover, it positively directs businesses towards their capitalization or a debt restructuring to the extent that it allows to carry forward interest expenses which are not deductible in a single tax year without any time limitation. On the contrary, the former tax regimes set out a final impossibility, although limited, to deduct interest expense which was not eligible for deduction in a single tax year. In other words, while the thin capitalization rules and the *pro rata* (*patrimoniale* and *reddituale*) rules required to determine the amount of interest expenses which qualified as finally not deductible, the current system exclusively provides for a temporary non deductibility of interest expense.

Unlike the previous regime, the scope of application of the new one is not limited to financing related to the acquisition of corporate stocks qualifying for the participation exemption regime or to loans directly or indirectly granted and/or guaranteed by shareholders.

Unlike the previous regime, the scope of application of the new one is not limited to financing related to the acquisition of corporate stocks qualifying for the participation exemption regime or to loans directly or indirectly granted and/or guaranteed by shareholders.

The main feature of the new regime relies on the fact that the benchmark to be met to determine the amount of deductible interest expense is no longer the amount of the venture capital, but the amount of profits that can bear the cost of debt financing. Under the thin capitalization rule such latter element was only indirectly relevant to the extent that the taxpayer was allowed to demonstrate its own and independent ability to obtain credit which could justify the amount of the debt financing. For the purposes of such assessment the analysis of the company flow of profits were of course material.

Moreover, the new rule differs from the DIT as it did not provide for any incentive purpose. It also differs from the thin capitalization rule which limited the maximum level of debt financing which could be borne based on the amount of the net worth; whilst the new rule just limits the amount of interest that may be deducted each year for tax purposes but does not limit the amount of debt financing. However, the rule currently applicable does not regulate the requalification as dividends of interests expense and thus does not direct the choices of the operators[42].

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[42] In any case, art. 46 ITA sets out that "*the sums paid to commercial enterprises and entities mentioned in art 73, para. 1, lett. b), by their members or participants qualify as loans if the accounts or other statements of such entities do not show that the payment was made for another reasons*". It introduces the rule according to which sums paid by shareholders are assumed to be borrowed (debt financing), unless the taxpayer proves the opposite. This rule is interpreted in a restrictive way by case law (see Supreme Court decision no. 14573 of 20 November 2001) according to which, for example, not even the circumstance that the company has a limited number of shareholders, or is owned by a single family, nor the fact that no interest result to be paid according to the accounts to the shareholders, allows to overcome the mentioned presumption. Such amounts are thus included in the determination of taxable income, save for the application of a withholding tax pursuant to art. 26, para. 5 of the Presidential Decree No. 600 of 1973, as clarified by case law (see Supreme Court decision no. 8747 of 4 April 2008, Supreme Court decision no. 6257 of 4 May 2001), regardless of the actual payment of the interest.
Therefore, this rule shows that, between the two possible qualifications, the legislator preferred to qualify the sums granted by a shareholder as a loan rather than as venture capital.
In literature L. Castaldi, *Redditi di capitale*, in *Giurisprudenza sistematica di diritto tributario – L'imposta sul reddito delle persone fisiche*, coordinated by F. TESAURO, I, Torino, 1994, p. 250; F. Padovani, A*rt. 46 (Versamenti dei soci)*, in *Commentario breve alle leggi tributarie*, by G. Falsitta, A. Fantozzi, G. Marongiu, F. Moschetti, Tomo III – TUIR e leggi

The new system provides for a pre-defined amount of deductible interest expense, leaving to the operators the greatest freedom of choice within this framework. While the former rules, either in a rewarding or in a punitive way, directly oriented the taxpayers choices, the current system does not intervene in a decisive manner in neither direction. In particular, whilst under the thin capitalization rule the limitations on the deductibility of interest expenses hit only those arising from transactions with related parties, under the current system the source of the funding is not relevant so that it is possible that also expense related to transactions supported by valid economic reasons may become non deductible[43].

It follows that the current system does not seem to be able to effectively counteract tax avoidance schemes put in place by taxpayers since it does not even identify them.

In other words, the new rule applies in a too general manner, almost witnessing the existence of a quantitative relevance of the principle of inherence. It seems to set out a threshold (the amount of interest income and 30% of the EBITDA) up to which interest expenses are allowed to be deducted; whilst beyond such threshold they are no longer, although temporarily, relevant for tax purposes. Neither the DIT nor the thin capitalization rule generated a similar effect.

The current provisions do not meet a specific tax neutrality logic since they are affected by the overall system: the reform reduced the tax rate according to a policy extremely similar to the one adopted in Germany. As pointed out by literature[44], the financial difficulties of the State Budget do not allow for a relevant loss of revenues, and the reduction by 5,5 points of the tax rate had to be financed by a tough restructuring of the taxable basis.

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complementari, coordinated by di A. Fantozzi, Padua, 2010, p. 237; A. Piri, A*rt. 46 (Versamenti dei soci)*, in *Commentario al Testo Unico delle Imposte sui Redditi*, by G. Tinelli, Padua, 2009, p. 363.

[43] T. Di Tanno, A*rt. 116 (Interessi passivi)*, in *Commentario breve alle leggi tributarie*, di G. Falsitta, A. Fantozzi, G. Marongiu, F. Moschetti, Tomo III – TUIR e leggi complementari, coordinated by A. Fantozzi, Padova, 2010, p. 502; D. Stevanato, *Indeducibilità degli interessi passivi e "genuinità" del finanziamento: istanza di disapplicazione preclusa?*, in *Corr. trib.*, 2008, p. 2694.

[44] S. Biasco, *La nuova riforma dell'imposizione sulle imprese a confronto con le conclusioni della Commissione sull'Ires*, in *Il Fisco*, 2007, p. 6203.

3. The taxation of dividends and interest in the hands of the recipient.

The consequences of the legislator's choices with respect to tax arbitrage between the debt and equity funding should also involve the tax treatment applicable on the relevant proceeds. However, it should immediately be noted that the method of taxation (tax credit, exemption, use of substitutive taxes) from time to time chosen by the legislator in relation to such item of income (and in particular in relation to profits) are not directly aimed at fighting the aforementioned phenomena. Such goal, in particular in the current tax system, can be deemed as pursued not at the level of profits and interest taxation, but at the level of the identification of the instruments originating profits or interest.
The lack of neutrality of the Italian tax system may arise from a further circumstance: the sale of shares, bonds and similar securities give rise to taxable capital gains, but also to tax deductible capital losses (falling within the “other income” category). Whilst under the category of income capital losses or negative income have no relevance, the category of “other income” may well give rise to capital losses thereby allowing taxpayers to operate some forms of tax arbitrage.

3.1. Financial instruments in the ITA: securities similar to shares, securities similar to bonds and atypical securities.

3.1.1. Qualification issues under the former ITA.

Under the tax regime in force prior to the Corporate Income Tax Reform, art. 41, para. 2, ITA provided that "*for the purposes of income tax, participations in the share capital of entities, other than companies, subject to corporate income tax qualify as similar to shares; the following items are considered similar to bonds: c) mass securities containing the unconditional obligation to pay at maturity an amount not less than that indicated in* *them, with or without the payment of periodic earnings, and which do not confer to the holders any rights of direct or indirect management of either the issuer or the deal in relation to which they were issued, nor any control right over the management itself*"[45].

The ITA distinguished between shares (and thus securities giving rise to dividends) and bonds (and thus securities giving rise to interest) based on the fact that a security either attributed or not a participation in the issuer. In the affirmative case, that security qualified as a share; in the negative case, such lack of participation right was not sufficient to ensure that the security fell within the category of bonds. Indeed, it was necessary to check the existence of a further requirement: namely the fact that security guaranteed the repayment of the capital invested. In the lack of such condition, the relevant security fell within the broader category of atypical securities.

3.1.2. Qualification issues under the current ITA.

The above mentioned tripartite system was questioned after the Corporate Income Tax Reform enacted with Law no. 80 of 2003 in order to take into account the changes made by the company law reform implemented by Legislative Decree No. 6 of 17 January 2003. This latter reform introduced major changes to the Italian Civil Code provisions on company law and, as a consequence, suggested the Government to appoint a special Commission (the so-called Gallo Commission) requested to work on the coordination of tax legislation with the changed company law background in order to make sure that the Legislative Decrees implementing art. 3 and 4 of Law No 80 of 2003 (Corporate Income Tax Reform) took into account the reform of company law just implemented[46].

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[45] Also "*interest bearing bonds issued by companies selling vehicles in instalments pursuant to art. 29 of the Royal Law Decree no. 436 of 15 March 1927, converted into Law no. 510 of 19 February 1928*" were deemed to be similar to bonds.

[46] For such purposes, Law no. 326 of 24 November 2003, upon conversion into law of the Law Decree no. 269 of 30 September 2003, passed art. 39, para. 14-*octies*, through which it completed the provisions of art. 10 of Law no. 80 of 7 April 2003 in order to set out that the

The proposal put forward by Gallo Commission to reach a bipartite system revolving around the notions of securities similar to shares and securities similar to bonds was not accepted and the category of atypical securities was preserved. However, the other two categories were amended consistently with the new company law background[47].

To adapt the ITA system to the new company law, the tax legislator amended art. 41, para. 2 (now art. 44) ITA where it provides for the definition of, respectively, securities similar to shares and securities similar to bonds.

Art. 44 ITA in its paragraph 2, lett. a) qualifies similar to shares all securities and financial instruments the remuneration of which is entirely represented by the participation in the economic performance of the issuer company or of other companies within the same group or of the deal in relation to which they were issued[48].

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implementation decrees for articles 3 and 4 should take into account the company law reform enacted through Legislative Decree no. 6 of 17 January 2003.

[47] In brief and limited to what of interest here, please note that the company law reform in order to simplify the funding of stock companies widened their possibility to issue financial instruments having a participative or not nature, allowing the maximum autonomy in this respect. The civil code provisions now do not set limits to the content of the rights attributable to the holders of the new financial instruments, so that they may take the legal form that better address the nature of the funding granted and of the contributions made. In other words, it is entrusted to private autonomy, as expressed in the articles of association, the possibility of providing forms of remuneration in various ways linked to the company profits and to set the repayment of a contribution qualifying it as a real loan, or by including it into an associative relationship characterized by the sharing of business risks (G. Visentini, *Principi di diritto commerciale,* Padua, 2006, p. 262). The number of tools that companies can use for raising capital directly was thus increased, on one hand allowing them to make exceptions to the traditional categories of shares and bonds (even up to blur the differences between the two categories of securities), the other giving the right to issue financial instruments other than shares and bonds. The major innovation introduced by Legislative Decree no. 6 of 2003 is, therefore, the introduction of the category of financial instruments which stand between shares and bonds. Such instruments are characterized by being issued against contributions not reflected in the net worth, although goods contributed (in cash or in kind) are theoretically attributable to the net worth. The legislation, in fact, correctly uses the term “attribution” and that of “contribution” to highlight the nature of the relationship being established between the issuer and the underwriter. These are equity instruments that do not grant the position of shareholder (as they are not related to the contribution of values recorded in the net worth), although they may be granted the right to vote on matters specifically mentioned (except for the general shareholders meeting), such as the appointment of the board of directors or of an auditor (art. 2351, para. 5, Italian civil code). The subscriber has an exclusively claim property rights (the right to profit or to the liquidation, at a certain time, of the net asset value of the good attributed) or administrative rights (which related to the functioning of the general meeting or to the management activity), but not the right to participate in the share capital of the company itself.

[48] *Amplius* G. Corasaniti, *Azioni, strumenti finanziari partecipativi e obbligazioni: dalla riforma del diritto societario alla riforma dell’imposta sul reddito delle società*, in *Dir. prat. trib.*, 2003, p. 875; M. Piazza, *Azioni, obbligazioni e strumenti finanziari partecipativi nella*

The category of securities treated as shares is therefore structured based on the nature of its remuneration and not based on the risk underlying the investment, which is the principle which grounds the definition of bonds. Pursuant to art. 44, para. 2, lett. c) ITA, the following items qualify as similar to bonds: "*mass securities containing the unconditional obligation to pay at maturity an amount not less than that indicated in them, with or without the payment of periodic earnings, and which do not confer to the holders any rights of direct or indirect management of either the issuer or the deal in relation to which they were issued, nor any control right over the management itself*"[49].

It follows that the new ITA does not resort to a unique criterion to describe the two categories under scrutiny, but simultaneously reverts to the criterion of return on investment and to the criterion of risk underlying the investment, thus giving rise, as already mentioned, to a confusion that requires the interpreter to search for guidelines.

To solve these issues, it must also be noted that art. 109, para. 9, lett. b) ITA provides for the non-deductibility from the issuer's business income of the remuneration of securities and financial instruments, however named, regulated by art. 44 ITA, in case they allow a direct or indirect participation in the issuer's economic results. This rule represents the natural consequence of the assimilation to shares of those securities the return of which is linked to economic results of their issuers. Since the income earned by the holders of such securities are qualified as profits, this assimilation must likewise apply to the issuer companies in order to deny the deductibility of these items of income, so that it would not have been correct to allow the issuer company to deduct the relevant remuneration as a cost.

In conclusion, the effects of the provision set out in art. 109, para. 9, lett. a), ITA imply that the remuneration of securities and financial instruments are totally non deductible for tax purposes, for reasons of systematic

riforma fiscale, in *Il fisco,* 2004, p. 620; M. Basilavecchia, *Gli utili da partecipazione in società non residenti*, in *Corr. trib.*, 2005, p. 827.

[49] Besides interest bearing bonds issued by companies selling vehicles in instalments pursuant to art. 29 of the Royal Law Decree no. 436 of 15 March 1927, converted into Law no. 510 of 19 February 1928"

coherence, such remuneration must be subject to the tax regime applicable on dividends, provided that it entirely consists in the participation to the economic performance of the company[50].

Therefore, it is the joint provisions of art. 44, para. 2, lett. a) and of art. 109, para. 9, lett. b) ITA that provides for the interpretative key of the new system in which the remuneration principle prevails over the risk principle, while conflicts between the provisions set out in letters a) and c) of art. 44, para. 2 ITA must be resolved in favour of the former.

In conclusion, the qualification for tax purposes of the new financial instruments regulated by the new company law must follow one of the following criteria:

1. the remuneration and its reference amount;
2. the obligation to fully repay the principal;
3. the granting of participation rights.

These criteria, however, do not operate on an equal level: the principle of remuneration must be applied in the first instance, as to allow a first distinction between securities similar to shares and not. This initial distinction is not exhaustive, since, within the category of securities not similar to shares, it is necessary to identify the boundaries of a narrower area that includes securities similar to bonds. The legislation only defines the second, therefore the first must be defined by difference: it covers securities that are not similar to shares nor to bonds. It is a residual category resulting from the insufficient coordination of the relevant provisions and is now fully useless, especially in the light of the amendments set out by Law Decree no. 138 of 13 August 2011, converted into Law no. 148 of 14 September 2011, which will be shortly examined.

From the issuer's perspective, art. 109 ITA applies and it does not require to distinguish whether a security qualifies as atypical or not. Indeed, its scope of application is wider than that of art. 44 ITA. While the latter considers financial instruments as shares when their remuneration is "totally" represented by the participation in the issuer's economic

[50] On the criticalities of the position taken by the legislator please see G. Fransoni, *Scelte di fondo e criticità nel sistema impositivo degli strumenti finanziari*, in *Strumenti Finanziari e Fiscalità*, 2011, p. 15.

performance, upon determination of the business income, the non deductibility for tax purposes operates not only for the remunerations linked to the economic results of the issuers, but also on a pro rata basis for those only partially linked to the performance of the business. Therefore, different regimes apply to the holder of a security (the remuneration of which is only partially linked to the profits of the company) for whom the same is not qualified as a share pursuant to art. 44 ITA and for the issuer for which, however, the related remuneration is only partially deductible. This way the need for a symmetrical treatment, which is deemed fundamental to coordinate the new regimes also by the tax authorities, is disregarded, however the anti-avoidance function performed by such two provisions is enhanced. Indeed, said provisions are aimed at preventing that financial instruments allowing a participation in the issuer's profits may be used to deduct from business income also profit distributions under the guise of financial charges[51].

3.2. The taxation of shares and of securities similar to shares.

Through the Corporate Income Tax Reform, the Italian legislator has deeply amended the tax regime of dividends or profits. Until 2003, the legislator addressed the issue of removing economic double taxation through the tax credit method. The Corporate Income Tax Reform changes such approach: indeed, it repeals such method, replacing it with the exemption method, although it also sets forth some substitutive taxation mechanisms[52].

It is renown that the exemption and the tax credit method provide for equivalent results for the purposes of removing double taxation; however

[51] F. Gallo, *Schema di decreto legislativo recante "Riforma dell'imposizione sul reddito delle società" (Ires) - Audizione informale presso la Commissione finanze della Camera dei Deputati*, in *Rass. trib.*, 2003, p. 1661.

[52] And pass through forms of taxation. The implementation of this mechanism has been confirmed with reference to the partnerships and has been extended to limited liability companies in case of option provided specific requirements that, in a nutshell, are represented by a restricted number of shareholders, are met.

the meet different general aims[53]: whilst the credit method excludes the advantage of producing foreign income (so-called *Capital Export Neutrality*) – which is an aim that may be found to breach the freedom of capital movement in the European framework -, the exemption method offers the same conditions to enter all markets (so-called *Capital Import Neutrality*).

The choice of the first or second method must be made taking into account the EU legislation. Indeed, the need to remove discriminations in the tax treatment of dividends based on the residence of the distributing company[54] has been stated in various occasions by the European Court of Justice[55] and by the Commission[56]. More in detail, the latter did not express any preference for one of the two methods, but stated that Member States may freely adopt one or the other provided that the method chosen applied without any distinction to both domestic source and European source dividends.

All Member States, including Italy, opted for the exemption method since, ordinarily, no State grants a tax credit for foreign source dividends in relation to the taxes paid by the company distributing them in its home State.

The implementation of the exemption method has occurred in a very complex and detailed way since it is necessary to distinguish on the basis of:

- the nature of the beneficiary of the dividends (individual, sole trader and partnerships, companies subject to corporate income tax);

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[53] P. Pistone, *Il credito per le imposte estere ed il diritto comunitario: la Corte di giustizia non convince, (Nota a CGCE 12 maggio 1998 (causa C-336/96); CGCE 14 settembre 1998 (causa C-291/97))*, in *Riv. dir. trib.* 2000, p. 76.

[54] A. Di Pietro, *La nuova disciplina dell'IRES: la tassazione dei redditi dei non residenti ed i principi comunitari*, in *La riforma dell'imposta sulle società*, coordinated by P. RUSSO, Torino, 2005, p. 126.

[55] European Court of Justice, decision 6 June 2000 on Case C-35/98, *Verkoijen*, concerning a provision of the law of a Member State that granted a tax exemption only provided that such dividends are paid by companies established in that Member State; European Court of Justice, decision15 July 2004 on Case C-315/02, *Lenz*, concerning a legislation allowing only holders of domestic source income from capital to choose between a flat tax levied at 25% and ordinary income taxation at a rate reduced by one half; European Court of Justice, decision 7 September 2004 on Case C-319/02, *Manninen*, concerning a provision under which the right for resident individuals to a tax credit on dividends paid by companies limited by shares is excluded where the latter are not established in the same State.

[56] EU Commission, *Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee - Dividend taxation of individuals in the Internal Market*, Bruxelles, 12 December 2003, COM(2003)810 final.

- the kind of participation held;
- the source of the dividends.

For the benefit of entities subject to IRES it is expressly provided that profits distributed by other entities subject to IRES and then, basically by businesses, fall within the corporate income tax taxable basis only limitedly to 5% of their amount, while the remaining 95% is fully exempt (the 5% taxable portion has been determined as a forfeit amount corresponding to the proportion of non-deductible costs associated to the production of the relevant profit).

The above portions of exempt and taxable dividends are quite different for individuals carrying on a business activity. Indeed, with regard to such categories of taxpayers, it is provided that the taxable portion of the dividends received amounts to 49.72%, whilst the exempt portion is equal to 50.28%.

The criterion concerning the nature of the participation held is relevant in determining the tax treatment applicable to dividends paid to individuals and not linked to their business activities. With respect to such individuals the tax regime indeed changes depending on whether the participation held amounts to:

- *a qualified interest*: which means a participation (i) granting an overall percentage of voting rights exercisable in the ordinary shareholders' meeting equal to:
  • more than 2% in case of listed shares;
  • more than 20% in case of non listed shares;

  or (ii) corresponding to an holding of stock capital:
  • exceeding 5% in case of listed shares;
  • exceeding 25% in case of non listed shares;
- *a non qualified interest*: which means a participation which does not exceed the aforementioned thresholds.

Dividends received by an individual not exercising a business activity and holder of a qualified participation fall within the individual taxable income limitedly to 49,72% of their amount (whilst the remaining 50,28% is exempt). Dividends received by an individual not exercising a business activity and holder of a non-qualified participation are subject, pursuant to art. 27 of Presidential Decree no. 600 of 29 September 1973, to a substitutive tax levied at 20% (which replaces the previous tax rate of 12,5%) starting from 1st January 2012 as a consequence of the amendments made by Law Decree no. 138 of 13 August 2011, converted into Law no. 148 of 14 September 2011. Such substitutive tax applies on the entire amount of the dividends received (which do not benefit from any of the exemptions mentioned above).

The first effect of such latter amendment is an increase of the tax burden on non qualified participations which, considering both the taxation levied on the company and that on the shareholder, is equal to approx. 42% (*i.e.* the sum of the 27,5% tax rate on the company and the 20% on the dividend paid to the shareholder, whilst such amount was previously equal to 36,5% as the sum of 27,5% and of the then applicable substitutive tax of 12,5%), whilst that on qualified participations ranges approx. between 35,8% and 43% (*i.e.* the sum of the 27,5% tax rate on the company and the 23% or 43% on 49,72% of the dividend levied in the hands of the shareholder).

The above regimes (tax exemption and substitutive tax) are applicable in relation to all dividends distributed by both resident and non-resident companies, provided that such dividends are not directly or indirectly paid by companies resident in tax haven countries or territories, unless it can be demonstrated through a ruling request that the participation in such tax haven resident companies does not allow to localize the relevant income in said countries. Indeed, pursuant to art. 47, para. 4 ITA the profits "arising"[57] from companies residing in the so-called tax havens are fully taxable.

The regimes above described apply, in substance and with some simplifications, also for the taxation of capital gains arising from the sale of shares by both companies and individuals, since capital gains are deemed to represent future flows of discounted profits. To prevent tax avoidance, the

[57] On the meaning of such term, please see Ministry Circular no. 28 dated 4 August 2006; Circular no. 51 dated 6 October 2010.

legislator has provided that capital losses are relevant for tax purposes to the same extent in which the corresponding capital gains would be taxed[58].

Following the above analysis, it appears that the Italian legislator opted to structure the issue concerning the taxation of corporate taxpayers and of their shareholders in the sense of splitting the relevant taxation among the two parties involved[59]. At present, if compared to the past, corporate income tax is regarded as a final taxation directly in the hands of the corporate entity, which qualifies as a fully taxable entity not only under a legal perspective, but also under an economic point of view. Such final taxation at the company level is then completed by a further final taxation of the same profits at the shareholders level.

This approach is based on the current corporate income tax structure: unlike the former corporate income tax mechanism, the company ceases to be a sort of "filter" for the purposes of the final taxation of the shareholder. The issue arising from the adoption of such principle is that of determining the maximum overall tax burden for both the shareholder and the corporate entity.

At present such tax burden ranges between 35,8% and 43% in case of qualified participation and is equal to 42% in case of non qualified participation. Similarly to the tax credit method, the overall tax burden on business income is equal to the higher marginal individual income tax rate. Although under an economic perspective the two systems are equivalent, under a juridical perspective they are extremely different (with the credit method the tax paid by the company qualified as a mere payment on account of the taxes due by the shareholder) and implied a different approach to the matter.

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[58] A single exception shall be mentioned with respect to capital losses realized by companies which are fully non deductible, whilst capital gains are taxed limitedly to 5% of their amount.

[59] This aspect derives from the wording of art. 1, para. 38, Law no. 244 of 24 December 2007 (so-called Budget Law for 2008) which, following the reduction of the corporate income tax rate to 27,5% set out that "*to ensure the invariance of the level of taxation of dividends and capital gains, in relation to the reduction of the corporate income tax rate set forth by para. 1 of this article, the percentages referred to in articles 47, para. 1, 58, para. 2, 59 and 68, para. 3, ITA will be determined by a decree of the Minister of Economy and Finance*". The ministerial decree dated 2 April 2008 identified in 49,72% the portion of profits taxable in the hands of the qualified shareholder, as to bring the overall tax burden equal to 43% on the gross profit.

Moreover, it must be pointed out that the most recent amendments to the tax rate level on income from capital as of 1st January 2012 may give rise to a constitutionally unlawful distortion at least with respect to non qualified participations: indeed, the owners of non qualified participation may be subject to a tax burden higher than that borne by the owners of qualified participations subject to lower marginal tax rates.

3.3. The taxation of bonds, of atypical securities and of securities similar to bonds.

The tax regime applicable to income arising from the ownership of bonds, securities similar to bonds and atypical securities, of both domestic or foreign source[60], ordinarily consists in the application of a withholding at source or of a substitutive tax[61] levied at a rate of 20% as of 1 January 2012[62] (instead of at the former 12.5% rate), following the amendments made by Law Decree no. 138 of 13 August 2011, converted into Law no. 148 of 14 September 2011[63].

[60] The income from capital arising from interest earned by resident individuals are, in fact, taxable regardless of where they are received. Therefore, not only income arising in Italy is taxable, but also foreign source income paid by non-residents is taxable. Also these later, in a nutshell, are subject to withholding or substitute taxes at 20%. Italy thus pursues the aim of ensuring that investing in Italy or abroad is substantial the same for Italian residents.

[61] The substitute tax is applied by banks, securities firms (*società di intermediazione mobiliare* - SIM), trust companies, by stockbrokers and other entities specifically listed in specific decrees issued by the Minister of Finance with the agreement of the Minister of the Treasury, which must be resident in Italy and that are involved in the collection of interest, premium and other proceeds, or in the transfer of securities even acting as buyers.

[62] On the topic please see V. Amendola Provenzano, P. di Felice, *Il regime delle ritenute e delle imposte sostitutive sulle rendite finanziarie*, in *Strumenti Finanziari e Fiscalità*, 2011, p. 27.

[63] The description of the rules for the taxation of profits (arising from non-qualified participations) and interest, capital gains and losses must be completed pointing out that the substitute tax can be levied directly also by the taxpayer indicating them in its tax return (so-called “tax return regime”) or by the intermediary with which they are deposited and which is entrusted with their administration (so-called “assets management regime”). Taxpayers are then allowed to include such securities in individual portfolio management (so-called “individual portfolio management regime”). In this case a 20% tax is levied not on the proceed earned, but on the result accrued over the year and determined as the difference between the value of the assets at year-end than the beginning of the year. These different tax treatments clear represent a breach of the homogeneity principle.
Such differences are now stressed if reference is made to the taxation of income derived from a collective portfolio. This is the case of investment funds the tax regime of which is regulated by art. 26-quarter of Presidential Decree No. 600 of 1973, as amended by Law no.

Art. 2, para. 6 of the mentioned Decree provides that withholding taxes and substitutive tax applicable on interest, premiums and all other income regulated by art. 44 ITA and on the category “other income” governed by art. 67, para. 1, letters from c-*bis* to c-*quinquies*, ITA shall be levied at a rate of 20%. In other words, withholding taxes and substitutive taxes on income from capital (interest and other income arising from loans, deposits and current accounts, interest and other proceeds arising from bonds, proceeds from individual asset management or from investment funds, but also, as mentioned above, gains from non-qualified participations) and capital gains having a financial nature (capital gains realized by the sale versus consideration of securities, financial instruments, mass certificates, foreign currencies, and also of non-qualified stocks and shares) will be subject to a single tax rate applicable at 20%, instead of the previous rates of 12.5% and/or of 27%.

The single rate of 20%[64] is not applicable neither to interest, premiums and all other income from capital, nor to capital gains related to:

- government bonds and other similar securities (*i.e.* bond issued by the State treasury and assimilated securities issued by territorial entities, as well as interest bearing postal deposits);

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10 of 26 February 2011, converting into Law Decree no. 225 of 29 December 2010. Until that changes, the taxation of Italian law OICR was linked to the result of asset management and a substitutive tax was levied on the income accrued. The tax was levied on the increase in value recorded each year, the funds acted as withholding tax agents and the underwriters were taxed on potential income, although not yet realized through the disinvestment (taxation of the "accrued" income). In the case of a negative performance of the assets managed, and therefore of the accrual of a loss in the hands of the fund, the previous system implied the arising of a tax credit in the hands of the fund. However, the taxation on the gains accrued has been abolished and a 20% tax applies on income realized, thus bridging the competitive disadvantage of Italian funds with respect to foreign ones. In particular, the legislator passed art. 26-*quater* of Presidential Decree no. 600 of 1973 which provides that, with effect from 1 July 2011, income from the participation in collective investment funds based in Italy, other than real estate funds, and those located in Luxembourg (but already authorized to sell their quotas or shares in Italy), limitedly to the shares sold in Italy, will be subject to a 20% withholding tax upon payment. In this way, it appears that the taxation of the income accrued remains the tax regime applicable to the sole individual portfolio management for which the taxpayer opted for the individual portfolio management regime, while, except for this hypothesis, the entire system operates through a 20% taxation on income earned by the investor.

[64] It is not applicable also to interest paid by Italian companies to subsidiaries of foreign companies (i.e. companies from other EU countries affected by the provisions of Directive 2003/49/EC that are taxed with a 5% final withholding tax and to profits paid to persons resident in the EU or EEA countries included in the white list subject to a 1,375% withholding tax.

- bonds issued by white list States included in the list regulated by art. 168–*bis* ITA;
- securities issued for the southern economy;
- duly established long term saving plans.

The amendment has therefore removed the main source of inconsistency in the treatment of the securities at hand that justified a tax driven choice among debt financing and venture capital[65].

The possibility of qualifying a security as a share, a bond or an atypical security has become totally irrelevant since, save for dividends arising from qualified participations, the remuneration of all other securities is subject to taxation at 20%; therefore it is no longer necessary to identify securities subject to tax at 12.5% (usually bonds) and those subject to tax at 27% (usually atypical securities). In the former regime, such different tax treatments gave rise to relevant tax planning.

However, the recent amendments did not remove the tax planning grounds in relation to the use of either debt financing or venture capital. It is true that the recipient is subject, except when it holds a qualified participation, to tax at 20%, but the topic concerning the deductibility for the issuer company of the amounts paid (profit or interest) remains unsolved.

A further open issue is that concerning capital gains, or rather capital losses. Reference is made to those conducts providing for the transfer of securities in order to obtain a tax relevant capital loss, circumventing the principle according to which capital losses should not be relevant. The mechanisms based on substitutive taxes are, indeed, applied to capital gains arising from the sale of the securities at stake, however, in such a case, also capital losses become relevant for tax purposes and they reduce the amount of the corresponding gains realized in the same tax year or in subsequent years.

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[65] These were in fact taxed at rates of 12.5% or 27% depending on whether the investment was or not speculative. Hints on such nature were:

a) the maturity of the investment: if longer than 18 months;
b) the type of issuer: it was deemed that the securities issued by listed companies or by the State revealed a lower propensity to speculation because in such cases opportunities for the investor to take part to the entrepreneurial policies were really low, if any.

Although the recent amendments do no longer allow the taxpayer to opt among the various tax rates applicable, it still allows the taxpayer to overcome the rule setting out the tax irrelevance of capital losses and to deduct it for tax purposes.

4. Conclusions in respect of the tax neutrality principle.

The description of the applicable legislation here provided confirms the impression (as stated from the beginning) of a substantial lack of neutrality within the Italian tax system that allows different forms of tax planning. Italy appears to be far and away from the economic model[66] mentioned in the introduction under which interest deductible for the company as taxable at progressive rates at the shareholder's level[67] and non-deductible profits for the company as non taxable income in the hands of the shareholders.

However, as clarified by the Biasco Commission[68], "*neutrality is not an only economic but also a legal goal. It refers to the need to ensure substantial equality between taxpayers with essentially the same ability to pay. There is no doubt that this principle is breached whenever enterprises with similar characteristics and potential ability to pay are taxed differently depending on their financial decisions*", so that this principle must be strictly pursued by the legislature.

Examining the matter from the enterprise's perspective, it is clear that the current wording of art. 96 ITA is very *trenchant*. The legislator did not structure it in order to ensure neutrality to the tax system since it operates regardless of the potential tax planning between debt and equity financing. It substantially sets out the amount of deductible interest expense as a flat

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[66] S. Giannini, *Gli interessi passivi nel quadro della tassazione societaria internazionale*, quot., p. 14.

[67] In Italy, the progressive taxation on interest occurs within the scope of application of art. 46 ITA which, as already highlighted, assume that the funds granted by the shareholders qualify as interest bearing loans which are fully included in the shareholders' taxable income. This rule, however, does not apply in all cases (which often and ordinarily occur in practice) in which the loan is represented by a security.

[68] Commission for the study of corporate income taxation (so-called Biasco Commission following the name of its Chairman) established with decree of the Vice Ministry of Economy on 27 June 2006.

amount which is entirely independent of the operational strategies of the company with the effect of limiting the deductibility of both pathological and physiological debts, or rather, providing an improper definition of physiological debt. Under an enterprise perspective, it can be noted how the legislator until now considered as alternative instruments those aimed at favouring the capitalization (the dual income tax) and those aimed at contrasting the excess of debt financing (the thin capitalization rule).

They are not necessarily incompatible among themselves. The Biasco Commission[69] suggested both the reintroduction of the DIT (although in the form of an aid to the economic growth - named called "*ACE*") and the maintenance of a specific anti-avoidance legislation to prevent the thin capitalization (including, among conducts subject to the anti-avoidance rule governed by art. 37-*bis* of Presidential Decree No. 600 of 29 September 1973, also the qualified shareholders' improper use for tax purposes of the subsidiary thin capitalization whenever a certain threshold of debt granted by said qualified shareholders or by their related parties). This option could be usefully pursued as it would achieve equality between taxpayers with different ability to pay taxes by way of duly distinguishing among physiological and pathological debt financing.

Having a look at the matter under the shareholders' perspective, it can be noted that the domestic tax system, despite the recent changes, does not yet effectively oppose the resort to the use of debt financing: the relevant proceeds do not fall within the overall taxable income but are subject to particularly low substitutive forms of taxation (usually levied at 20%), whilst the taxation of the remuneration of venture capital remains extremely high (ranging between 38,5 and 43%) considering the aggregate level of taxation at both the company and the shareholder's level.

The recent amendments has further increased it, at an aggregate level, and has mainly disadvantaged the taxation on non qualified participations, which is now higher than that levied on qualified participations held by shareholders benefiting from a lower individual income tax marginal rate.

[69] Commission for the study of corporate income taxation (so-called Biasco Commission), *Final Report*, available on the web site of the Ministry of Economy and Finance – Department for the tax policies.

This aspect gives rise to a constitutional lawfulness of the substitutive taxation, in the lack of the right for such taxpayers to opt between the substitutive taxation at source and the tax regime set out for qualified participations.

The introduction of a single tax rate equal to 20% does not exclude the advantage consisting in the deductibility for the company of the interest borne (*versus* the non deductibility of the profits) and leaves unchanged the issue concerning the taxation of profits arising from qualified stockholdings. This change, although certainly relevant (if only for having, in fact, polarized the system between two extremes: income arising from qualified participations and income derived from all the other financial securities), is not yet enough to guarantee the neutrality of the tax system. It does not yet prevent transactions aimed at realizing tax deductible capital losses: to solve the lack of relevance of "capital losses" category would require a complete restructuring of the category of income from capital.

The legislator thus demonstrates that it does not effectively oppose such phenomena unlike case law that in several occasions has issued decisions on this point. Reference is made to the relevant number of decisions[70] that recognized the existence of a general principle in domestic law, which existed even before the enactment of anti-avoidance laws and that finds its origin in the Constitutional Law, which prohibits to taxpayers to achieve unfair tax advantage through a lawful use of legal tools which are not based on sound economic reasons. Such principle is specifically developed in relation to financial transactions so that the Supreme Court[71] stated that "*the caution that must guide the application of the principle, whatever its source may be, should stand at maximum levels when the transaction is not of a financial nature (as it is the case of dividend washing and dividend stripping)*". The weak reaction of the legislator in this respect is contrasted by a strong reaction by case law that is demonstrating its will to fight all potential tax arbitrage available under the current regime. Without mentioning the criticalities raised by the mentioned case law, since it falls

[70] In particular, Supreme Court decision no. 30055 of 23 December 2008; Supreme Court decision no. 30057 of 23 December 2008.

[71] Supreme Court decision no. 1372 dated 21 January 2011.

out of the scope of the present work, as to what may be of interest here, it should be noted that even this approach is not satisfactory as it is not able to provide a real legal certainty.

A direct position taken by the legislator would be highly preferable: since an absolute neutrality of the tax system is probably too a complex goal to be reached (unless it is obtained through an overall restructuring of the tax system), the legislator could well extend the position taken against dividend washing through paragraphs 3-*bis*, 3-*ter* and 3-*quater* of art. 109 ITA[72]. In other words, it could be possible to set out a general rule which may fight tax arbitrage between debt and equity financing and between income from capital and other income following the guidelines provided by the Supreme Court and which may allows taxpayers to choose between one or the other form of financing, between one of the other form of income, provided that such choice is supported by sound economic reasons.

[72] Through the amendment at hand, the legislator established the non-deductibility of "capital losses realized pursuant to art. 101 on shares and financial instruments similar to shares that do not meet the requirements of art. 87 ... up to the amount of non-taxable dividends, or their advance payments, received in the thirty-six months prior to the transfer. This provision also applies to the negative difference between the profits regulated by art. 85, para. 1, lett. c) and d), and the relevant costs". In other words, this provision set out the non-deductibility of capital losses realized upon sale of shares and financial instruments similar to shares if:

1) the transfer relates to equity securities held for less than thirty-six months and that at the same time:
   a) do not fall under the participation exemption regime (since, as noted, any tax loss or negative difference, realized upon their sale is irrelevant for tax purposes);
   b) meet, in any case, the objective requirements set out for the application of the participation exemption regime, connected with the tax residence of the subsidiary and the activity carried out by the same;
2) in the thirty-six months preceding the sale, the security sold gave rise to the distribution of dividends.