Changes to the tax regime of dividends and capital gains under the Italian Budget Law for 2018.

The Italian Budget Law for 2018 (Law. No. 205 of December 27th, 2017) provides for some material changes to the tax regime of dividends and capital gains. In particular, they affect dividends and capital gains arising from "substantial" shareholdings and dividends deriving from entities that are resident of low-tax jurisdictions.

Dividends and capital gains from "substantial" shareholdings

The Italian Budget Law 2018 modifies the tax regime of capital gains and dividends arising from "substantial" shareholdings and concretely aligns it to the one applicable to "portfolio" shareholdings.

In this respect, it is worth remembering that we deal with a "substantial" shareholding if it represents *(a)* more than 20% (or 2% for listed companies) of the voting rights or *(b)* a participation to the capital higher than 25% (or 5% for listed companies). Conversely, should these thresholds not be exceeded the relevant shareholding qualifies as a "portfolio" shareholding.

The new regime affects *(a)* resident individuals who do not hold the shares in connection to a business activity, and *(b)* non-resident persons (individuals or entities) that do not hold the shares through an Italian PE.

(a) Dividends and capital gains arising from substantial shareholdings held by resident individuals and not connected to a business activity are now subject to a 26% final withholding or substitute tax (as well as those deriving from portfolio shareholdings. Therefore:

- any foreign income tax paid on foreign-sourced dividends or capital gains is not creditable against the flat 26% tax;
- the taxable base of foreign dividends received through Italian-based intermediaries (on which the 26% Italian flat tax applies) is reduced of any foreign withholding tax;

The new regime does not concern dividends and capital gains arising from shareholdings held in entities that are resident of low-tax jurisdictions as (save exceptions) they keep on being fully included in the overall income tax base and subject to progressive taxation (in this case, foreign income taxes may be creditable).

(b) Capital gains realized on substantial shareholdings held in Italian resident companies by non-resident persons (that do not hold the shares through an Italian PE) are now subject to a final 26% substitute tax (unless a DTT prevents Italy from taxing thegain). As a general rule (i.e. unless a more favourable domestic or conventional regime applies), also before these changes non-resident persons were subject to a 26% withholding tax on dividends deriving from substantial shareholdings held in Italian resident companies.

The regime at stake generally applies to dividends paid as of January 1st, 2018 and to capital gains realized as of January 1st, 2019. Notwithstanding, the previous tax regime applies on to dividend that are paid out of profits earned until the FY that was running on December 31st, 2017 and whose distribution is declared between January 1st, 2018 and December 31st, 2022.

Dividends deriving from entities that are resident of low-tax jurisdictions

Dividends from companies that are resident of (or otherwise located in) low-tax jurisdictions are generally subject to income tax on their full amount when received by Italian resident individuals or companies. In this context, we deal with a low-tax jurisdiction if it:

(a) is not an EU or EEA member State;

(b) and provides for a nominal tax rate that is lower than 50% of the Italian nominal tax rate (or otherwise grants a preferential tax regime to the distributing company resulting in a final taxation that is lower than 50% of the Italian nominal tax rate).

As a matter of fact, a foreign jurisdiction may therefore qualify as low-tax in a given FY but not in another FY. In this respect, the Italian Budget Law for 2018 (overcoming the Circular Letter No. 35/E of August 4th 2016) clarifies that dividends distributed by a non-resident company out of profits accrued in a FY during which the distributing company's residence jurisdiction did not qualify as low-tax are subject to the (more favourable) ordinary tax regime (95% exemption for dividends received by resident companies and Italian located PEs, 41.86% exemption for dividends received by individual entrepreneurs and resident partnerships and 26% withholding/substitute tax for dividends received by resident individuals arising from shareholdings that are not connected to a business activity). Moreover, it has been also specified that, to this aim, profits earned at the time when the distributing company's residence jurisdiction did not qualify as low-tax must be considered as distributed first.

The Italian Budget Law for 2018 also introduced a new rule whereby dividends distributed by a company that is a resident of a low-tax jurisdiction benefit from 50% exemption in the hands of the Italian resident company who receives such dividends, if it is demonstrated that the distributing company runs a core business activity that is actually tied to the local market of the jurisdiction where it is a resident. Moreover, if the Italian company controls the distributing foreign company, it shall also be entitled, in principle, to an indirect tax credit for up to 50% of the underlying foreign corporate tax paid by the distributing company.

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