Italy's PEX regime raises doubts among taxpayers

Luca Galliani of LED Taxand takes a closer look at recent amendments to Italy's PEX regime in case of foreign subsidiaries, and considers why taxpayers may need further clarity.

Article 5 of the Legislative Decree November 29 2018, No. 142 (Article 5) – that has made amendments to the tax regime of dividends and capital gains derived from participations in foreign entities – was introduced with the purpose of aligning these provisions with Italy's new controlled foreign corporation (CFC) regime, as implemented following the ATAD 1 and ATAD 2 Directives.

The repeal of the definition of privileged tax regime in the context of the CFC regime as well as the introduction of a new concept of 'control' as provided by Article 7 of the ATAD 1 Directive had a significant impact on the taxation of cross-border dividends and capital gains.

However, following the amendments, including the provision of new criteria for qualifying a foreign state or territory as blacklisted, several doubts have arisen among the scholars, in particular with respect to the taxation of dividends and capital gains derived from participations held by taxpayers before 2019, namely the year in which Article 5 entered into force.

Analysis

Article 5 introduced in the Italian tax code (TUIR) the new Article 47-*bis*, relevant for both dividends and capital gains, that provides criteria for identifying a blacklist jurisdiction on the basis of the shareholders' position.

Starting from the fiscal year 2019, a foreign jurisdiction, different from EU/EEA member states, should be considered as blacklisted if:

- In case of qualified participations, the foreign entity is subject to an effective tax rate lower than 50% of the effective tax rate that would have applied if that entity was tax resident in Italy; and
- With regard to non-qualified participations, the nominal foreign tax rate (as established by also taking into account special tax regimes) is lower than 50% of the nominal tax rate.

In addition, among the amendments introduced by Article 5, those concerning the participation exemption (PEX) regime applicable in case of disposal of the participations are of interest.

According to Article 87 of the TUIR, the applicability of the PEX regime is subject to the fulfillment of four requirements, namely (i) the minimum holding period of 12 months preceding the disposal; (ii) the booking of the participations as a fixed financial asset (long-term investment) in the first financial statement; (iii) the residence of the participated company in a white-listed country; and (iv) the carrying on by the participated company of a real business activity.

As far as requirement (iii) is concerned, Article 87, paragraph 1, let. c) TUIR now recalls the new rules provided by Article 47-*bis* TUIR or, alternatively, requires that the taxpayer is able to prove (also through a tax ruling) that the participation in the foreign entity did not result in the shifting of the income to states or territories with a privileged tax regime.

In addition, it is now provided that, if the transfer occurs between unrelated parties (i.e. that are not member of the same group), this condition must exist continuously for the last five years prior to the disposal. On the other hand, in case of intra-group disposals the condition must exist since its first fiscal year of holding.

Those two amendments are of relevant interest and must be analysed carefully.

It is worth noting that the criteria to consider a state as blacklisted have changed several times over the years. In particular:

- Until December 31 2014, states and territories with a privileged tax regime were identified on the basis of the so-called 'blacklist' contained in the Ministerial Decree November 21 2001, issued by the Ministry of Economy and Finance;
- For fiscal year 2015, states and territories with a privileged tax regime were those (i) identified by Ministerial Decree November 21 2001, as amended during that year; or (ii) the special regimes which, in any case, allowed a level of taxation lower than 50% of that applied in Italy even if provided for by states or countries not included in the mentioned 'black-list';
- Starting from the fiscal 2016 and until 2018, the blacklist contained in the decree of November 21 2001 was abandoned, and a jurisdiction was considered as blacklist if its nominal income tax rate was lower than 50% of the combined CIT and IRAP rates. Furthermore, a jurisdiction may also qualify as a low-tax jurisdiction in the case of special tax regimes that (i) are applicable to all taxpayers that meet certain requirements; and (ii) directly or indirectly entail (through exemptions to the taxable base) a reduction of the income tax rate.

In this context, the problem that arises for all the taxpayers that own participations before the fiscal 2019 is the identification of the criteria to be applied in order to verify the residence (black or white) of the foreign entity. In other terms, it must be questioned if for the fiscal years prior 2019 the criteria pro tempore in force become applicable or reference should be made to the new rules as set forth by art. 47-*bis* TUIR.

To better frame the problem, first of all, it is appropriate to recall the conclusions reached in the Circular Letter August 4 2016, No. 35 (Circular Letter No 35) where the tax authorities specified that the source of the dividends (or capital gains), namely from a privileged tax regime or not, must be determined on the basis of the criteria in force at the time of their payment (disposal), regardless their previous qualification (so called 'cash basis' principle). This interpretation gave rise to the following situations:

- In the event that the subsidiary was qualified as blacklist based on the provisions in force in the year(s) in which the dividend was accrued (the participation was held), a double test was necessary. Indeed, the 95% exclusion (exemption) was, in any case, granted if – by applying the criteria in force at the time of the payment – the company was considered whitelist in both the year of the dividend payment (sale of the participation) and the year(s) in which the profit accrued (the participation as held);
- On the other hand, if the subsidiary was qualified as whitelist based on the provisions in force in the period in which the dividend was accrued (the participation was held), the exemption was granted if – by applying the criteria in force at the time of the payment – the company was also considered whitelist in the year of the payment. A double test was not necessary in this case.

Thus, this interpretation freed from the full taxation the dividends that, even though were treated as blacklist on the basis of the prior rules, qualified as whitelist by applying retrospectively the new criteria. In other terms, blacklist dividends and capital gains could turn into whitelist according to the different approach adopted ex post by the Italian legislator (so-called 'bleaching' of the dividend/capital gain).

However, at the same time, this principle led to the situation in which dividends (capital gain) peacefully deemed as whitelist on the basis of the criteria pro tempore in force were transformed into blacklist when, at the time of the payment and on the basis of the rules applicable at that time, the company was deemed to be resident in a blacklist state.

In this context and with specific reference to dividends, with the clear intent to remedy this unlucky situation, the 2018 Budget Law (Law December 27 2017, No. 205) with the Article 1, paragraph 1007 ruled that dividends accrued in a year in which, based on the rules pro tempore in force, the company was considered whitelisted may obtain the 95% exclusion treatment, even though – at the time of the distribution – it qualified as blacklisted under the new qualification criteria.

Part of the scholars believed that the new rule was meant to totally override the conclusions reached by the tax authorities with Circular Letter No. 35 and to switch to a pure 'accrual basis' principle, according to which the profits are deemed to be white or black on the basis of the rules in force in the year in which they accrued.

However, in some rulings – such as the Principle of Law May 29 2019 No. 17 and the Ruling January 12 2021 No. 38 – the Italian tax authorities took a different position by pointing out that the purpose of the new rule is simply to exclude the retroactive application of the new tests when whitelist profits would become blacklist if the new rules were applied. In other terms, Article 1, paragraph 1007 of the 2018 Budget Law only applies when the qualification of the participation switches from whitelist to blacklist and not also on the other way round. In the latter case, according to the tax authorities, the guidelines provided in the Circular Letter No. 35 remain applicable.

Under this perspective – as pointed out by other scholars – Article 1, paragraph 1007 of 2018 Budget Law must be interpreted as a derogatory provision to the general principle that provides for the taxation of the dividends on the basis of the rule in force at the time of the distribution.

In this sense, this rule – that had the purpose to safeguard the correctness of the taxpayers' conducts adopted in the past – cannot be interpreted as a 'transitional' provision that introduces the accrual basis principle, because it only refers to the situation in which, at the time of the distribution, the foreign entity is considered as blacklist but it was whitelist (under the condition pro tempore in force) when the profits were accrued.

However, Assonime, namely the main association of Italian joint stock companies, with its Circular Letter No. 15, May 7 2021, highlighted that the provision at stake should be given a more important meaning and should confirm the principle according to which that the assessment of the nature (i.e., black or white) of the participated entity must be made by applying to each period the rules pro tempore in force.

That being said, it is worth noting that the 2018 Budget Law did not address the issue of the residence of the participated entity for the purposes of the Italian participation exemption regime in case of capital gains. However, according to Assonime the same conclusions reached in the context of the dividends should necessarily apply also for these purposes. Therefore, Assonime believes that the nature (white or black) of the participations must be assessed by applying, for every single year of ownership, the rules ratione temporis in force.

The main consequence deriving from the Assonime's interpretation would be that, in situations where the participated entity was considered as blacklist under the provisions pro tempore in force but is treated as whitelist under the new rules, the aforementioned bleaching phenomenon would be denied and, therefore, the capital gains would be fully taxable. In addition, Assonime highlighted that the possibility to confirm for PEX regime purposes the applicability of the bleaching phenomenon would be justified only by interpreting it as an 'equitable' rule, aimed to give relevance to the new criteria if more favourable.

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Doubts arise

Following the amendments introduced by Article 5 several doubts have arisen among the scholars with respect to the taxation of dividends and capital gains derived from participations held by Italian taxpayers before 2019 and for which we guess new guidelines will be issued by the Italian tax authorities.

With specific reference to the capital gains, on one hand, according to Assonime, a systematic interpretation of the legal framework at stake should lead to the conclusion that, for the application of the PEX regime, the residence of the participated entity from the first year of ownership (or for the last five years) must be verified by applying, for every single year, the rules ratione temporis in force.

Such a conclusion would require that the Italian tax authority must confirm also for PEX regime purposes the bleaching phenomenon when the participated entity would be deemed to be blacklist under these rules.

On the other hand, prominent scholars believe that the source of the capital gains, namely from a privileged tax regime or not, must be determined on the basis of the criteria in force at the time of the participation disposals. Indeed, Article 1, paragraph 1007 of 2018 Budget Law can only be interpreted as a derogatory provision that have the purpose to safeguard the correctness of the taxpayers' conducts adopted in the past.