INVITALIA

Agenzia nazionale per l'attrazione
degli investimenti e lo sviluppo d'impresa SpA

The tax system

INVITALIA

Invitalia is the Italian national agency for inward investments and economic development. Its mission is to promote the country competitiveness – in particular in the Southern Regions – and support growth in strategic sectors.

Its main objectives are:

- *Supporting inward investments*
- *Boosting innovation and growth*
- *Improving the economic opportunities in the country.*

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Reform of the tax system

Italy's corporate taxation system recently underwent a major reform, with subsequent additional amendments.

The main features of the new tax system are:

- **reduction of the corporate income tax rate** to 27.50%
- a **partial exemption** (95%) of capital gains on the sale of equity investments in Italian or foreign companies ("participation exemption");
- the abolition of the tax credit system for dividends and introduction of **partial tax exemption** (95%) of dividends from equity investments in Italian or foreign companies;
- introduction of a **ceiling on the deductibility** of interest expense equal to 30% of the gross operating income of industrial or commercial companies;
- introduction of a **ceiling on the deductibility** of interest expense for financial companies, equal to 96% in 2009 and 97% in 2008;
- introduction of a **group taxation mechanism** under which Italian and foreign companies belonging to the same group may compute one taxable income for the parent company resident in Italy;
- **tax exemption** of capital gains reinvested in start-ups.

Types of tax and withholdings

Direct taxes

Personal income tax (Imposta sul Reddito delle Persone Fisiche - IRPEF)

Personal income tax is governed by Italy's uniform income tax code (*Testo Unico delle Imposte sui Redditi – TUIR)*.

Individuals resident in Italy for tax purposes are subject to IRPEF on income earned in Italy and abroad.

Individuals who are not resident in Italy for tax purposes are subject to IRPEF only on income earned in Italy.

Taxable income is taxed at progressive rates that currently rise from 23% to 43%[1].

Corporate income tax (Imposta sul Reddito delle Società - IRES)

Corporate income tax is also governed by the TUIR.

Companies resident in Italy for tax purposes are subject to IRES for income earned in Italy and abroad.

Companies that are not resident in Italy for tax purposes are subject to IRES only on income earned in Italy.

Taxable income is taxed at a rate of 27.50%[2].

Regional business tax (Imposta Regionale sulle Attività Produttive - IRAP)

The regional business tax is a local tax levied on the value of production generated in each tax period in the Italian regions by persons engaged in business activities. Non-resident companies are subject to IRAP only on the value of production generated by permanent establishments in Italian territory.

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[1] For greater details, see **Personal income tax** (p. 7).
[2] For greater details, see **Taxation of resident companies** (p. 11) and **Taxation of non-resident companies** (p. 20).

Indirect taxes

Value added tax (VAT)

Italian rules governing value added tax comply with the relevant Community directives.

In principle, the system is designed to ensure the tax is only paid by final consumers, as businesses can generally deduct VAT paid at intermediate stages of production.

VAT is generally levied on each sale of goods and/or services carried out in Italian territory.

The ordinary VAT rate is 20%.

Registration fees and other property transfer duties

Registration fees are levied on specific written instruments made in Italy or written instruments made abroad where they regard the transfer of real property or enterprises located in Italian territory. The tax base and applicable rate vary in relation to the type of instrument and the parties involved.

Property transfers are also subject to other duties (*imposta ipotecaria* and *imposta catastale*). Such duties are due in respect of the formalities associated with the registration of transfers in public property registers.

Registration fees and other property transfer duties are either fixed (€168.00) or proportional to the value of the asset being transferred (with rates of between 3% and 15% for registration fees depending on the instruments or assets involved, 2% for the *imposta ipotecaria* and 1% for the *imposta catastale*).

Municipal property tax (Imposta Comunale sugli Immobili - ICI)

Municipal property tax is due annually from holders (resident in Italy or abroad) of real rights in immovable property located in Italian territory, with the exception of households' primary residence.

The tax base is the equal to the registry value of the property, which is given by the imputed property income multiplied by a given coefficient.

The rate is set by each municipality within a range varying from 0.04% to 0.07%.

Inheritance and gift tax

Inheritance tax is applied to transfers of assets or rights as a result of death (with the exception of the transfer of Italian government securities, receivables from the Italian State or units in investment funds in the amount of any Italian government securities held). It is levied on the value of the individual shares assigned to each heir at a rate varying from 4% to 8%.

Gift tax is applied to transfers of assets or rights as a result of donations or other gratuitous transfers and to the establishment of restrictions on use.

The tax is levied on the value of the individual shares assigned to each beneficiary at a rate varying from 4% to 8% .

In the case of immovable property, the *imposta ipotecaria* (2%) and the *imposta catastale* (1%) are due in addition to inheritance or donation tax, without prejudice to the benefits applicable to primary residences.

Transfers of enterprises or controlling stakes in enterprises to descendants or spouses are exempt from inheritance or gift tax. The beneficiary is required to continue the business activity or retain control for five years from the transfer date.

Withholding tax

The three main withholding taxes are those levied on **dividends**, **interest** and **royalties**.

Withholding tax on dividends

Dividends distributed by Italian or non-resident companies received by individuals outside the scope of a business activity are subject to a withholding tax in settlement of 12.5% where they regard non-qualifying holdings.

Qualifying holdings consist of shares (other than savings shares) and any other investment in the capital or equity of a company to which are attached voting rights in the ordinary shareholders' meeting exceeding 2% or 20% if the securities are traded on a regulated market or 5% or 25% in other cases.

Dividends received by individuals outside the scope of a business activity regarding a qualifying holding in Italian companies are not subject to withholding tax, whereas those regarding foreign companies are subject to a 12.50% withholding tax on account for the taxable portion of profit, namely 49.72% of the total (with a consequent filing requirement and deduction of any credit for taxes paid abroad), net of any withholding tax applied in the foreign country. In applying the withholding, account is taken of double taxation agreements which could provide for the reduction or elimination of the tax.

Where the dividends are distributed by a foreign company resident in a country with a privileged tax regime (tax havens), the dividend shall be subject to taxation in full unless the taxpayer does not receive a positive response to an opinion request (*interpello*[3]) from the Revenue Agency.

[3] See **Opinion requests** (p. 29).

Dividends received by parties, other than individuals, who are not resident in Italy are generally subject to a withholding tax in settlement of 27% (the rate is reduced to 12.5% for dividends paid to holders of savings shares). However, where the non-resident parties are companies or entities subject to corporate income tax in the countries entered in the white list, the rate is equal to 1.375%.

Withholding tax on interest

In principle, interest on current accounts and deposit accounts with banks, as well as bonds and similar securities, received by persons who are **residents** of Italy for tax purposes is subject to a withholding tax of 27% or 12.5%, generally applied on account (gross interest is included in taxable income and the withholding is deducted from the gross tax). However, if the interest is received by residents outside the scope of a business activity, the withholding tax is applied in settlement and the interest does not form part of overall taxable income.

Interest on current and deposit accounts, as well as bonds and similar securities, received by non-residents is not subject to any withholding tax with the exception of persons resident in tax havens, for whom a withholding tax of 12.50% applies.

In general, interest on loans is subject to a withholding tax of 12.5% on account if received by persons **resident in Italy for tax purposes** other than persons engaged in a business activity. If the interest is received by persons **not resident in Italy for tax purposes**, the withholding is applied in settlement.

The withholding tax rises to 27% where the recipient is resident in a tax haven as identified in a specific ministerial decree.

The withholding tax may be applied at a lower rate if so provided for in any double taxation agreement[4] between Italy and the country of residence of the recipient.

In line with the provisions of the EU's Interest and Royalties Directive, withholding tax is not due on interest paid by companies residents in Italy for tax purposes or by permanent establishments in Italy of companies resident in the European Union to (i) resident companies or (ii) permanent establishments of companies resident in other Member States of the European Union. In accordance with the Directive, the benefit is applicable if all requirements concerning minimum holdings are met.

[4] See **International treaties** (p. 22).

Withholding tax on royalties

Royalties generated in Italy and received by a person who is not resident in Italy for tax purposes are subject to a withholding tax of 30% in settlement.

In certain cases, the taxable amount is reduced by 25% of total royalties. The withholding may be applied at a lower rate if so provided for in any double taxation agreement[5] between Italy and the country of residence of the recipient.

In line with the provisions of the European Union's Interest and Royalties Directive, withholding tax is not due on royalties paid by companies residents in Italy for tax purposes or by permanent establishments in Italy of companies resident in the European Union to (i) companies resident for tax purposes or (ii) permanent establishments of companies resident in other Members States of the European Union. In accordance with the Directive, the benefit is applicable if all requirements concerning minimum holdings are met.

[5] Ibidem.

Taxation of corporations resident in Italy

Corporate income tax (*Imposta sul Reddito delle Società* - IRES)

Entities subject to corporate income tax, rate and tax period

Corporate income tax applies to corporations resident or not resident in Italy.

Companies that are **resident** in Italy for tax purposes are subject to IRES for income earned in Italy and income earned abroad.

Companies that are **not resident** in Italy for tax purposes are subject to IRES only for income earned in Italy.

For tax purposes, the following forms of corporation are considered resident in Italy:

- *Società per Azioni* (S.p.A.)
- *Società a responsabilità limitata* (S.r.l.)
- *Società in accomandita per azioni* (Sapa).

Also considered Italian residents are foreign companies and entities that have their administrative headquarters or their main activities in Italian territory for the majority of the tax period. In certain circumstances, the administrative headquarters of foreign companies and entities is presumed to be located in Italy in any case.

Partnerships (*società in nome collettivo*, *società in accomandita semplice*) are not subject to IRES. The income produced by such entities is normally taxed using the rules envisaged for personal income tax (IRPEF),[6] with the income being attributed directly to the partners on the basis of their percentage holding in the entity. However, as from the 2008 tax period, partners may elect to tax such income separately at the same rate as that envisaged for corporate income tax (27.50%). This option may be exercised on the condition that such income is not distributed (a ministerial decree will establish the relevant implementing provisions).

For tax purposes, the tax period coincides with the financial year, as established in the articles of association or law. If not otherwise specified, the tax period coincides with the calendar year.

As from the tax period beginning on 1 January 2008, the IRES rate is equal to 27.50%.

[6] For greater details, see **Personal income tax** (p. 7).

Trusts

As from 1 January 2007, trusts whose registered office is in Italy and foreign trusts whose administrative headquarters or primary business are in Italy, are also subject to IRES.

The headquarters of foreign-registered trusts are presumed to be located in Italy if the trust is established in a country on the black list and:

- at least one of the trustors and at least one of the beneficiaries are resident in Italy for tax purposes;

or

- an Italian resident makes a contribution to the trust that involves transfer of ownership of real property or the establishment of restrictions on use of such property.

Taxable income

Taxable income is determined using the rules set out in the TUIR. Generally speaking, all income received by corporations resident in Italy for tax purposes is considered corporate income (*redditi d'impresa*), regardless of the nature of such income, and is taxed in accordance with the rules governing this category of income.

Taxable income is composed of net income produced anywhere during the tax period, as reported in the income statement, adjusted up or down in accordance with the rules envisaged in the TUIR. Taxable income does not include exempt income and income subject to withholding tax in settlement.

Without prejudice to a number of specific exceptions, the positive and negative components of income are considered for tax purposes on an accruals basis (one exception regards dividends, which are included in taxable income on a cash basis).

In order to determine taxable income for IRES purposes, it is necessary to distinguish the positive and negative components of income.

Positive components of income

- **Revenues**

  Revenues include the proceeds from: a) the sale of goods and services whose production or exchange is the focus of the business; b) the sale of raw and ancillary materials and semi-finished goods; c) the sale of shares, bonds and similar securities that are not classified as non-current financial assets.

- **Capital gains**

  Capital gains include the positive income components generated by the sale of the assets of the company other than assets that generate revenues (typically, capital gains are generated by the sale of non-current assets).

  Capital gains are included in taxable income for the tax period in which they are realised or, if the assets have been held for at least three years, in equal instalments over five years beginning in the year in which they are realised. These rules also apply to capital gains generated by the realisation of equity investments (other than those qualifying for the participation exemption) recognised under non-current financial assets in the last three financial years.

  Partial exemption of capital gains on the disposal of equity investments (participation exemption)

  As from the tax period beginning 1 January 2008, 95% of capital gains realised by companies resident in Italy for tax purposes on the disposal of equity investments in corporations/partnerships resident in Italy or abroad are IRES-exempt.

  Equity investments eligible for such treatment are those classified as non-current financial assets, engaged in commercial activities, held continuously for at least twelve months and resident for tax purposes in a country or territory other than a tax haven (white list countries).

  Capital losses, writedowns and expenses in respect of the disposal of equity investments that qualify for the participation exemption are not deductible.

  Exemption of capital gains on the disposal of equity investments reinvested in start-ups

  As from 25 June 2008, capital gains earned by resident individuals and non-residents of any nature on the disposal of equity investments in partnerships and corporations established no more than seven years earlier and held for at least three years do not form part of taxable income if they are reinvested in companies engaged in the same business within two years of their realisation.

  Partial exemption of dividends

  – Dividends received from corporations resident for tax purposes in Italy or a country or territory other than a tax haven are excluded from taxable income for IRES purposes in the amount of 95%.

Negative components of income

In general, negative components of income (costs and expenses) can be deducted from taxable income as long as they:

- are related to the business, i.e. contribute to producing taxable income;
- are recognised in the income statement.

Costs and expenses generally related to the production of exempt income and taxable income can be deducted in an amount corresponding to the ratio of taxable revenues to total revenues.

Interest – Ceiling on deductibility

As from 1 January 2008, industrial and commercial companies can fully deduct interest expense and similar charges (not capitalised in the cost of assets) in an amount equal to interest income and similar revenues. The excess may be deducted up to a ceiling of 30% of gross operating profit (*Risultato Operativo Lordo* - **ROL**). ROL is equal to the difference between item A (Value of Production) and item B (Production Costs) in the income statement increased by depreciation and amortisation of property, plant and equipment and intangible assets and lease payments. This limit is increased by € 10,000 for 2008 and €5,000 for 2009.

Interest expense that cannot be deducted (because it exceeds such limit) can be carried forward to subsequent tax periods if and to the extent in which the amount of interest expense and similar charges for such periods is less than 30% of ROL.

As from 1 January 2010, the portion of ROL not used in a given tax period because it exceeds the amount of interest expense may be carried forward to increase ROL in subsequent years.

Specific rules apply in the case of companies participating in the consolidated taxation mechanism.[7]

A ceiling on the deductibility of interest expense was also introduced for financial companies as from 2008 (97% in 2008 and 96% in 2009).

[7] See **Taxation on a consolidated basis** (p. 17).

Tax losses, withholding taxes and tax credits

Tax losses

A tax loss arising in a given tax period can be deducted from taxable income in subsequent periods up to a maximum of five years. Tax losses may not be deducted from taxable income generated in previous tax periods.

Tax losses arising in the first three tax periods following the date a company is formed may be deducted from total income in subsequent tax periods with no time limit, on the condition that the losses regard a new business.

Withholding taxes

Income received by corporations resident in Italy for tax purposes are subject to withholding tax in a limited number of situations (e.g. interest on current and deposit accounts, interest on certain bonds and similar securities).

Dividends and royalties are not subject to withholding tax.

Withholdings on income received by companies resident for tax purposes in Italy are generally made on account, and thus represent an advance payment of IRES. Income subject to withholding tax is included in the taxable income of the recipient and the withholdings are subsequently deducted from gross IRES.

Credits for taxes paid abroad

If taxable income includes income earned abroad, corporations resident in Italy for tax purposes are entitled to deduct any tax effectively paid on such income abroad from their gross IRES liability.

The tax credit for taxes paid is equal to the lesser of:

- the tax paid abroad;
- the portion of Italian tax related to the income earned abroad (determined on the basis of the ratio of foreign income to total income).

A number of double taxation agreements entered into by Italy give persons resident in Italy for tax purposes a specified tax credit, even if the tax levied in the original country is less than the credit or no taxes are levied at all.

Taxation on a consolidated basis

Companies resident in Italy for tax purposes belonging to the same group may elect to adopt the consolidated taxation mechanism.

Under this mechanism, the income of the subsidiaries is attributed to the parent company.

Exercising the consolidated taxation option therefore involves calculating a single taxable income for the entire group, represented by the algebraic sum of the net profit or loss of the companies included within the scope of consolidation.

Regardless of the size of the stake held by the parent company, the consolidation process considers the entire net income of the subsidiaries.

This taxation mechanism makes it possible to offset the taxable income of some group companies against the tax losses generated by other group companies.

The option of electing consolidated taxation is subject to compliance with a number of conditions:

- the **parent company** must be resident in Italy for tax purposes or, if resident abroad, must be resident in a country with which Italy has a double taxation agreement. In addition, its holdings in the companies included in the scope of consolidation must be attributable to a permanent establishment in Italy;
- the **subsidiaries** must be resident in Italy for tax purposes, subject to the ordinary IRES system and not benefit from any reduction in tax rates;
- the consolidated companies must be **controlled** by the parent company. To this end, from the start of each tax period the parent company must directly or indirectly hold a majority of voting rights in the ordinary shareholders' meetings of the subsidiary and must be directly or indirectly entitled to more than 50% of the profits of the subsidiary;
- the parent company and the subsidiaries must have **the same financial** year, i.e. the same tax period, and must exercise the option for consolidated taxation jointly.

The election of the option has a duration of three years and may not be revoked.

It is not necessary for the consolidated taxation mechanism to be adopted by all subsidiaries.

Group taxable income is determined by the parent company as the algebraic sum of the taxable income of each consolidated company.

Non-deductible interest expense and similar charges attributable to a participant in the consolidated taxation mechanism (i.e. expense exceeding 30% of ROL[8]) can be used to reduce

[8] See **Interest - Ceiling on deductibility** (p. 15).

group taxable income if and to the extent that other participants in the consolidated taxation mechanism have not entirely used the available ROL for the deduction. This rule also applies for any excess carried forward, with the exception of that generated prior to participation in the consolidated taxation mechanism. For this purpose, under certain conditions the ROL attributable to the group's foreign companies may also be computed if they would satisfy the requirements for participation in the consolidated taxation mechanism if they were resident in Italy.

Taxation on a pass-through basis

Under the rules governing taxation on a pass-through basis, shareholders of corporations resident in Italy for tax purposes can elect to include the income of the companies in which they have a stake in their own taxable income.

More specifically, under the pass-through taxation mechanism, the taxable income of the corporation is directly attributed to each shareholder in proportion to its holding in the company.

The option of electing pass-through taxation may only be exercised if a number of conditions have been met, including:

- the shareholders must be corporations resident in Italy or resident abroad if the latter are not subject to withholding tax at source on dividends
- the percentage holding in profits and voting rights in the shareholders' meeting held by each shareholder must be no less than 10% and no greater than 50%
- the option must be elected jointly by the company and all the shareholders.

The election of the option has a duration of three years and may not be revoked.

Regional business tax (*Imposta Regionale sulle Attività Produttive* - IRAP)

The regional business tax (IRAP) is a local tax levied on the value of production generated in each tax period in the Italian regions by, among others, corporations resident in Italy for tax purposes.

The Reform required the Government to gradually eliminate IRAP. This must be implemented progressively by first permitting the gradual deduction of labour costs and other currently non-deductible costs from taxable income as calculated for IRAP purposes.

Taxable income and tax rate

Taxable income for IRAP purposes is equal to the net value of production generated in each Italian region and is calculated as the difference between the macro-categories A and B (with

the exception of a number of items) of the income statement as drawn up on the basis of Italian GAAP (for entities that draw up their financial statements in accordance with international accounting standards – IAS – the corresponding items are **considered**).

For industrial and commercial enterprises:

- **positive components** include all income, with the exception of: a) certain capital gains (those generated by the disposal of companies and equity investments); b) some extraordinary income components; c) financial income (dividends, interest);
- **negative components** include all costs and expenses, with the exception of: a) labour costs (with some exceptions); b) interest and finance charges; c) certain capital losses and negative components of extraordinary income.

IRAP is not deductible from taxable income as calculated for IRES purposes.

As from 1 January 2008 industrial and commercial companies are subject to an ordinary IRAP rate of 3.9%. However, the regions may change the rate by up to one percentage point for certain sectors. Where the rate is changed by the regions, it is adjusted on the basis of a coefficient of 0.9176.

The value of production is considered to be produced in a given region if the company has a fixed office in the region for at least three months of the tax period.

The net value of production is allocated among the regions in which the company's business is conducted on the basis of the labour costs attributable to each region.

A number of deductions from IRAP taxable income are envisaged for

- *New hiring*
- *Research and development personnel*
- *Employees hired on permanent contracts*

in order to reduce the "tax wedge", i.e. the **difference** between the overall cost incurred by the **enterprise** for **employees** and the **net compensation** received by those employees.

Taxation of non-resident corporations with a permanent establishment in Italy

Corporate income tax (IRES)

The income earned by companies not resident in Italy for tax purposes through a permanent establishment in the country is considered income produced from an Italian source and is therefore subject to IRES.

Except for a number of specific exceptions, the definition of permanent establishment used by the TUIR is that same as that envisaged in the OECD Model Double Taxation Convention.

In general, comprehensive income produced by non-resident companies through a permanent establishment in Italy must be calculated on the basis of a specific income statement for the operations of the permanent establishment, using the same rules governing the accounts of companies resident in Italy for tax purposes.

However, for the permanent establishments in Italy of non-resident companies, a number of components of income generated in Italy and received directly by the foreign company (i.e. without the participation of the permanent establishment) are nevertheless included in the taxable income of the permanent establishment (the doctrine of the "force of attraction" of the permanent establishment).

More specifically, the force of attraction operates for:

- capital gains and losses of assets associated with commercial activities conducted in Italian territory;
- profits distributed by corporations and entities resident for tax purposes in Italy;
- capital gains on the disposal of assets located in Italy and equity investments in companies resident for tax purposes in Italy.

Generally speaking, the force of attraction of the permanent establishment does not operate in cases in which the foreign company is resident for tax purposes in a country with which Italy has a double taxation treaty.[9] In this case, the income attributable to the permanent establishment is limited solely to the corporate income actually produced by that establishment.

[9] See **International treaties** (p. 22).

Regional business tax (IRAP)

Non-resident companies are subject to IRAP only on the value of production generated by permanent establishments located in Italian territory. The value of production is calculated in accordance with the same rules applied to resident companies.

Branch tax

Italian tax legislation does not establish any additional tax on the repatriation of income earned by non-resident companies through permanent establishments in Italy.

International treaties and Community directives

Double taxation treaties

Italy has established agreements to avoid double taxation with the following countries:

Albania	Ethiopia	Malta	United States
Algeria	Philippines	Morocco	South Africa
Argentina	Finland	Mauritius	Sweden
Australia	France	Mexico	Switzerland
Austria	Georgia	Mozambique	Tanzania
Bangladesh	Ghana	Norway	Thailand
Belgium	Germany	New Zealand	Trinidad and Tobago
Brazil	Japan	Oman	Tunisia
Bulgaria	Greece	Netherlands	Turkey
Canada	India	Pakistan	Ukraine
Czechoslovakia*	Indonesia	Poland	Uganda
China**	Ireland	Portugal	Hungary
Cyprus	Israel	United Kingdom	Soviet Union ****
South Korea	Yugoslavia***	Romania	Uzbekistan
Ivory Coast	Kazakhstan	Russia	Venezuela
Denmark	Kuwait	Senegal	Vietnam
Ecuador	Lithuania	Syria	Zambia
Egypt	Luxembourg	Singapore	
United Arab Emirates	Macedonia	Spain	
Estonia	Malaysia	Sri Lanka	

***** The agreement between Italy and Czechoslovakia applies to the Czech Republic and the Slovak Republic.
** The agreement between Italy and China does not apply to Hong Kong or Macao.
*** The agreements between Italy and Yugoslavia apply to Serbia and Montenegro, Croatia, Slovenia and Bosnia Herzegovina.
**** The agreement between Italy and the Soviet Union applies to the following countries: Belarus, Moldova, Armenia, Azerbaijan, Kyrghyzstan, Tajikistan and Turkmenistan.

The agreements generally establish more favourable tax treatment for persons not resident in Italy than would normally apply under domestic legislation.

Most of these agreements are based on the **OECD Model Double Taxation Convention**.

The EU Parent-Subsidiary Directive

Italy has transposed the provisions of the EU's "Parent-Subsidiary Directive", which is intended to prevent double taxation of the profits produced by companies resident for tax purposes in an EU Member State (subsidiary companies) and distributed to companies resident for tax purposes in another Member State (parent companies).

Under the new rules governing dividend taxation, dividends received by parent companies resident for tax purposes in Italy are IRES-exempt in the amount of 95%, regardless of the percentage holding in the subsidiary and period for which the investment has been held.

Under certain circumstances, dividends received by a parent company resident in another Member State are exempt from withholding tax or are entitled to reimbursement of any withholding applied.

In order to be eligible for the exemption, the parent company must, among other things, hold a direct shareholding in a subsidiary resident in Italy for tax purposes of at least:

- 15% for dividend distributions between 1 January 2007 and 31 December 2008;
- 10% for dividend distributions as from 1 January 2009.

In order to be eligible for the withholding exemption, the minimum shareholding in the Italian subsidiary must have been held without interruption for at least one year as of the dividend payment date. Otherwise, the parent company may request reimbursement of the withholding tax paid once the minimum holding period has elapsed.

The EU Merger Directive

Italy has transposed the provisions of the EU's directive on a common system of taxation of mergers, divisions, transfer of assets and exchanges of shares among companies resident for tax purposes in different Member States.

In line with the provisions of the directive, Italian tax law governs the conditions under which the tax neutrality envisaged for such restructuring operations shall apply.

The EU Interest and Royalties Directive

This directive abolishes withholding tax at source on payments of certain forms of interest and royalties between associated companies resident in different Member States of the European Union. The directive establishes an exemption from all withholding taxes on interest and royalty payments in the source Member State, with taxation only in the Member State in which the beneficial owner of the payments is resident.

The Italian Government implemented the directive with Legislative Decree 143 of 30 May 2005 (entering into force on 26 July 2005).

Entitlement to the exemption from withholding tax on payments made to companies resident in EU Member States is subject to the following conditions:

- the companies that receive the payments are final beneficiaries, not mere intermediaries;
- the company that makes (receives) the payment has a direct minimum holding of at least 25% of the voting rights in the company that receives (makes) the payment or a third company has a direct minimum holding of at least 25% of the voting rights in both the company that makes the payment and the company that receives the payment;
- the shareholdings to which the voting rights indicated in the previous point are attached have been held without interruption for at least one year.

Satisfaction of the conditions and qualifications necessary to be eligible for the exemption must be established by way of supporting documentation at the time the payment is made.

The implementing decree establishes that the new provisions shall apply to interest and royalties accruing as from 1 January 2004.

The implementing decree also introduces a withholding tax of 30% on compensation paid to non-residents for the use or grant for use of industrial, commercial or scientific equipment located in Italian territory.

Transfer pricing

Transfer pricing refers to the set of rules that, for tax purposes, govern the determination of prices in international transactions between companies belonging to the same group.

Italian tax legislation establishes that the components of income generated by transactions with foreign companies belonging to the same group must be measured at their so-called "normal value", i.e. on the basis of the average price of the same or similar goods and services in a free market at the same stage of commercialisation.

In 1980, the tax authorities issued a circular illustrating the methodologies and criteria for the correct determination of transfer prices. In general, such criteria are in conformity with the instructions issued by the OECD.

Taxpayers can ask the tax authorities in advance to assess the appropriateness of the methodologies they have adopted.

The "International Ruling" procedure is completed with the signing of an agreement with the tax authorities that is binding for a maximum of three years.

Foreign subsidiaries and associates

Italian law establishes provisions applicable to certain foreign subsidiaries and associates (CFCs[10]). These rules are intended to prevent the allocation of taxable income to companies resident for tax purposes in countries with privileged tax regimes (tax havens), which are identified on the basis of a specific ministerial decree.

More specifically, under certain conditions (for example, the percentage of holdings in the foreign company that benefits from the privileged tax regime), the income generated by the CFC, regardless of actual receipt, is attributed to the Italian shareholders in proportion to the size of the shareholding. In other words, regardless of the actual distribution of profits, the income generated by the CFC is included in the taxable income of the controlling party resident in Italy and as such subject to Italian taxation.

The CFC rules do not apply if:

- the CFC actually engages in an industrial or commercial activity in the country in which it is located;
- the shareholding does not give rise to a transfer of income to countries in which such income would be subject to a privileged tax regime.

In order to claim exemption from the CFC rules, the parent company resident in Italy for tax purposes must submit a request in advance to the Revenue Agency.

[10] Controlled foreign company rules, pursuant to Article 127-bis of the TUIR.

Taxpayer requirements

Income tax returns

Each year taxpayers must declare their taxable income by submitting a tax return to tax authorities.

Corporations resident for tax purposes in Italy must submit their tax return electronically by the end of the seventh month following the final month of their tax period.

Individuals resident for tax purposes in Italy must submit their tax return by 31 July if they do so electronically. Individuals who submit their returns on a paper form through an authorised intermediary (bank or post office) must do so by 30 June.

IRAP returns

As from the 2008 tax period, taxpayers subject to the regional business tax must submit a separate IRAP return (no longer in unified format with their income tax return) .

Payment deadlines

In general, payment of IRES and IRAP for each tax period is broken down into two advance payments and one final balance payment.

More specifically, for a given tax period:

- the **first advance payment** is due by the 16th of the sixth month following the first month of the tax period;
- the **second advance payment** is due by the final day of the eleventh month following the first month of the tax period;
- the **balance** is due by the 16th of the sixth month following the first month of the tax period.

In general, the same rules for payment of IRPEF and IRAP also apply to individuals resident in Italy for tax purposes.

Audits and disputes

Audits

The tax authorities conduct both formal and substantive audits of income tax returns.

Formal audits are designed to correct material errors and calculation mistakes made by taxpayers. The outcome of the check is notified to taxpayers, with a specification of the reasons for the adjustment to the amounts declared, which also enable the taxpayer to correct the data reported or settle the discrepancy quickly.

Substantive audits are intended to adjust taxable income or the VAT turnover reported by the taxpayer.

In such audits, the tax authorities may carry out inspections at the taxpayer's premises.

Where omissions or violations are found following such checks, the competent tax authorities issue an assessment.

Deadlines for assessments

For the purposes of assessments related to income tax and VAT, the deadline is 31 December of the fourth year following that in which the tax return was submitted.

If no tax return was submitted, the deadline is extended until 31 December of the fifth year following that in which the return should have been submitted.

These deadlines are doubled (31 December of the eighth year following that in which the tax return was submitted or 31 December of the tenth year following that in which the return should have been submitted) where the taxpayer has committed a violation for which the authorities are required to file a complaint accusing the taxpayer of one of the offences envisaged in Legislative Decree 74/2000.

Disputes

Notices of assessments and/or penalties issues by the tax authorities can be appealed to bodies responsible for adjudicating tax disputes.

Appeals against notices of assessments and/or penalties must be lodged with the Provincial Tax Commission within 60 days of notification. Rulings of the Provincial Tax Commission can be appealed by the tax authorities and by taxpayers to the Regional Tax Commission. The rulings of the latter can be appealed to the Court of Cassation (supreme court of appeal) by the tax authorities and by taxpayers only for questions of legality.

Opinion requests

Taxpayers can request an opinion from the tax authorities concerning interpretative uncertainties in the application of tax regulations to specific cases .

Taxpayers may also request a special type of opinion (a pre-filing opinion) to govern international issues concerning transfer prices, royalties and dividends.

The response to the request is valid for three years and, assuming no change in the factual or legal circumstances, is binding on the tax authorities.

Taxation of individuals

Natural persons resident in Italy are subject to personal income tax (IRPEF) on income produced in Italy and abroad.

Non-residents are only subject to IRPEF on their Italian income.

The tax period coincides with the calendar year.

Tax residence

Residents are individuals who, for more than half of the tax period, are:

- entered in the register of Italian residents;

or

- have their domicile or residence in Italian territory.

Pursuant to the Italian Civil Code, residence is the place in which individuals have their habitual abode, while domicile is the place in which their affairs are primarily conducted (the centre of their vital interests).

Unless otherwise demonstrated, residents also include Italian citizens removed from the register of Italian residents who have emigrated to a country or territory with a privileged tax regime, as identified on the basis of a specific ministerial decree.

Categories of income and taxable income

IRPEF is applied to individuals with income falling into one of the following categories:

- real property income
- investment income (e.g. dividends, interest)
- compensation of employees (e.g. salaries)
- income from self-employment (e.g. professional fees)
- corporate income
- other income (e.g. capital gains on the sale of shares or similar securities).

Each of these categories has different rules for determining taxable income.

Exempt income and income subject to withholding tax in settlement (e.g. interest on bonds, dividends) are excluded from the calculation of taxable income.

Certain components of income are taxed separately (except where the taxpayer elects to include such income in ordinary income if this is envisaged as an option). These include

severance pay, capital gains on the disposal of enterprises owned for more than five years, income from withdrawal from a partnership, etc.. Separation taxation takes account of the fact that certain forms of income are formed over a number of years, and therefore instead of the ordinary marginal IRPEF rate, it is taxed a rate equal to that which would apply to half of total income in the two previous years.

Compensation of employees earned from an activity performed abroad is taxed on the basis of a notional income set annually in a ministerial decree (for 2008, Ministerial Decree of 16 January 2008), regardless of the compensation actually received.

Tax rates

As from 1 January 2007 tax rates (by income bracket) are as follows:

Taxable income	Rate
Up to € 15,000	23%
€ 15,001 - € 28,000	27%
€ 28,001 - € 55,000	38%
€ 55,001 - € 75,000	41%
Over € 75,000	43%

The gross tax is determined by applying the IRPEF rates to global income, i.e. to the sum of all the incomes in the above categories, net of certain deductible expenses (medical expenses, alimony payments, pension and welfare contributions).

The net tax liability is determined by subtracting from the gross tax:

- exemptions for dependants (the amount declines as income increases);
- standard deductions for certain categories of income (compensation of employees and similar income, income from self-employment and corporate income for persons qualifying for simplified accounting);
- other deductions (e.g. primary residence and medical expenses).

The tax to be paid is calculated by subtracting any tax credits and withholding tax on account from the net tax.

The global income calculated for tax purposes, net of deductible expenses, is also subject to a regional IRPEF surtax, which can range from 0.9% to 1.4%, and a municipal IRPEF surtax, the

rate for which is set by the State with a consequent reduction of the IRPEF rates (to date, the State has never established any rate). Individual municipalities can adjust the base rate up to a maximum of 1.2%.

International accounting standards (IAS)

Article 25 of Law 306 of 31 October 2003 concerning the exercise of the options provided for by Regulation (EC) 1606 of 2002 granted the Italian Government enabling authority to extend the adoption of international accounting standards to the separate financial statements of listed companies in Italy as well as to the separate and consolidated financial statements of other companies whose securities are not listed on regulated markets in the European Union. The decree also provided for the option of permitting the adoption of international accounting standards by commercial companies.

In implementation of the enabling authority, the Government issued Legislative Decree 38 of 28 February 2005. In addition to regulation the accounting aspects, the decree also introduced legislative amendments governing the tax effects of the transition to/adoption of international accounting policies. These amendments were designed to ensure the neutrality of the transition/adoption, especially the need to prevent the transition to/adoption of the IAS from creating a benefit or disadvantage in respect of companies that draw up their accounts on the basis of the accounting standards ordinarily applicable to commercial companies.

However, with the 2008 Finance Act, the principle of tax neutrality has given way to differential treatment depending on the tax involved.

In particular, entities that have adopted the IAS are required:

- for income tax purposes, to apply the qualification, recognition and classification criteria envisaged in international accounting standards;
- for IRAP purposes, to calculate taxable income on the basis of the items corresponding to those adopted by persons applying Italian GAAP.

In addition, the 2008 Finance Act introduced numerous specific tax rules for IAS adopters. For example:

- the changes (increases or decreases) in values recognised in application of the IAS in respect of shares, bonds and similar financial instruments held for trading (not recognised under non-current assets) are now material for the purposes of direct taxation. Dividends received in respect of shares, units and similar instruments held for trading are fully taxable for the beneficiary. Conversely, no changes were made concerning the immateriality for tax purposes of changes in values recognised from the measurement of shares, units and similar instruments held as non-current assets ("not held for trading");

- the rules governing dividend washing[11] do not apply to IAS adopters, who are instead subject to specific rules under which the tax cost of shares, units or instruments comparable to shares meeting the requirements of the application of the participation exemption, with the exception of the holding period, is reduced by an amount equal to the tax-exempt share of dividends received during the holding period.

The implementing and coordination provisions governing these changes will be established with a specific ministerial decree.

[11] See **Participation exemption** (p. 14).