

# Italy's Participation Exemption Rules

by Marco Rossi

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*Editor's Note: On November 30, as this issue was going to press, Law Decree 203 of September 30, 2005, was finally approved and converted into law. The final version of the law further reduces the exempt portion of the gain realized by corporate shareholders to 91 percent for gains realized in taxable years beginning on or after January 1, 2006, and 84 percent for gains realized in taxable years beginning on or after January 1, 2007 (instead of the general reduction to 95 percent that had originally been provided for).*

Italy's new rules exempting gains realized from the disposition of corporate stock or other equity interests in noncorporate entities are a fundamental part of Italy's corporate income tax reforms of 2003-2004. The policy objectives of the new participation exemption rules<sup>1</sup> are threefold — first, to increase Italy's tax competitiveness and attractiveness as a location for holding companies (including holding companies of Italian groups established in other more favorable EU jurisdictions); second, to facilitate the transfer of an ongoing business by transferring the stock of the entity owning and operating the business rather than the business assets, thereby avoiding the corporate level tax that would otherwise apply to an asset transfer and the shareholder level tax on the gain from the sale of stock as a result of the exemption; and, third, to mitigate double taxation of corporate profits.<sup>2</sup>

<sup>1</sup>Those objectives are set out and illustrated in Law 80 of Apr. 7, 2003, in which the legislature granted the government specific authority to reform various areas of Italian corporate and international tax laws in accordance with the general principles and guidelines set forth therein, and in the technical report accompanying Legislative Decree 344 of Dec. 12, 2003, by which the government enacted the tax reforms under the authority delegated by the Parliament.

<sup>2</sup>Before the tax reforms of 2004, under Italian tax law the taxation of companies and shareholders was fully integrated. Companies could consolidate the losses of their subsidiaries with their own income or losses. Shareholders received a

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credit for the income tax paid by the company on its taxable income when earned, which they would use to offset their own tax liability or could claim as a refund (full imputation system). Companies could recognize and deduct unrealized losses on stock owned in subsidiaries that reflected the subsidiary's operating losses. As a result of the tax reforms of 2004, Italy moved to a classical system of taxation of corporate profits and disallowed recognition of unrealized stock losses. The imputation credit has been abolished and corporate profits are taxable both at the corporate and shareholder level. However, the double taxation of corporate profits is mitigated by reducing taxation of dividends and exempting gains from disposition of stock (subject to some requirements). Affiliated companies can elect to be taxed on a consolidated basis (thereby consolidating income and losses within the group) if the requirements for tax consolidation are met. Moreover, companies whose stock are owned by other companies can elect to be treated as fiscally transparent entities, with the effect that the company's income or losses are passed through to and are offset at the level of the shareholders. In particular, with regard to dividends and gains, 95 percent of the amount of dividends paid to corporate shareholders is exempt from tax. That is equivalent to taxing dividends at an effective tax rate of 1.65 percent. Sixty percent of the amount of dividends to individual shareholders is exempt from that, which is equivalent to a dividends tax at a maximum effective tax rate of 18 percent. No minimum stock ownership is required to benefit from the reduced rate of tax on dividends. Dividends paid to individual shareholders with respect to portfolio stock (*i.e.*, stock representing less than 2 percent of voting power or 20 percent of value, if publicly traded, or 5 percent of voting power or 25 percent of value, if nonpublicly traded) are subject to a 12.5 gross basis tax. Gains from sale of stock are exempt from tax if realized by companies and subject to tax at the maximum rate of 18 percent if realized by individuals with respect to qualified stock (*i.e.*, stock exceeding the above-mentioned thresholds). Gains realized by individuals with respect to nonqualified stock (*i.e.*, stock falling below the thresholds) are subject to a 12.5 percent gross basis tax. The above system of taxation of dividends and gains under Italian tax law can be compared to that provided for under U.S. tax law. In the United States, as a result of the dividends received deduction accorded by IRC section 243, intercompany dividends are taxed at an effective tax rate of 10.5 percent, reduced to 7 percent for dividends distributed by a 20 percent-owned company and down to zero for dividends paid by an 80 percent-owned company; qualified dividends paid to individuals and capital gains realized by individuals from the sale of stock are taxed at the preferential rate of 15 percent.

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type with a permanent establishment in Italy (but only on gains attributable to that PE). Gains potentially eligible for the exemption include those realized on stock held in a corporation or equity interests owned in noncorporate entities (whether resident or nonresident) and on securities or financial instruments issued by resident or nonresident persons classified as equity for Italian tax law purposes. The rules do not apply to gains from the sale of shares in mutual funds or other investment vehicles, which are subject to a separate preferential tax regime. Recognition events include: (1) a sale or exchange; (2) distributions in complete or partial liquidation of a company or in redemption of stock that are treated as a sale or exchange under the ordinary corporate tax rules; (3) distributions of capital reserves in excess of a shareholder's basis in the distributing company's stock; (4) involuntary conversion of stock into a claim for damages for the loss of value of the stock; (5) withdrawal of stock from a trade or business; and (6) issuance or transfer of limited rights on the stock or equity instrument. The requirements for the exemption do not include a minimum stock ownership in the participating entity. One general assumption for granting the exemption is that the corporate profits reflected in the value of the transferred stock have been subject to tax on the entity when earned. For that reason, gains realized on stock held in entities resident in tax-haven jurisdictions included in an appropriate blacklist are taxable in full. However, if the stock is not directly held in a blacklisted entity, but instead is held through a holding company that also owns stock in other nonblacklisted entities in an appropriate mix, it may be possible to obtain the exemption by selling the stock of the holding company also for the portion of the gain that reflects the inherent appreciation of the stock of the blacklisted company (and that would have been fully taxable had such stock been held and disposed of directly).

A trade-off of the exemption of gains is that realized losses on stock that qualifies for the participation exemption (including losses for worthlessness of stock), interest allocated to debt incurred to purchase stock that qualifies for the exemption, and expenses incurred in connection with the sale of that stock, are nondeductible.

The participation exemption rules are scattered in various sections of Italy's "Unified Code on Income Taxes."<sup>3</sup> Section 87, which applies to resident corporations, sets forth the general statutory provisions on participation exemption. Sections 56 and 58

<sup>3</sup>Reference is made herein to the "Unified Code on Income Taxes" of 1986 and subsequent amendments in force at the date of publication of this article (the "tax code").

extend the application of those provisions to gains realized by resident partnerships, albeit with some variations (the most notable of which is a reduction of the exempt portion of the gain to 60 percent of the total amount of gain). Section 152 extends the application of the provisions of section 87 to gains attributable to a PE in Italy of a nonresident entity, which are exempt from tax exactly in the same way as gains of resident corporations (that is, full exemption from tax). Sections 97, 101, and 109 contain rules that disallow a deduction for losses, interest, and costs related to stock eligible for the participation exemption.

### **The new participation exemption rules are particularly wide in scope.**

The tax administration has issued extensive administrative guidance on the interpretation and application of the participation exemption rules. Some initial guidelines are provided in paragraph 5.2 of Circular 25/E of June 16, 2004, and Circular 26/E of June 16, 2004. Specific guidance on the new participation exemption regime is provided in Circular 36/E of August 4, 2004. Additional explanations on various issues arising in that area are set forth in Circular 10/E of March 16, 2005, in the form of replies to specific queries raised by taxpayers. A bill with technical corrections and amendments to the law that enacted the tax reforms, adopted by the government on March 12, 2005, contained some changes to the participation exemption rules that, if enacted, would have put stricter limits to the application of the exemption. Those changes have been enacted with Law Decree 203 of September 30, 2005, passed in connection with the approval of the Budget Law for 2006, effective October 4, 2005.

Among the changes, the exempt portion of the gain has been reduced from 100 percent (that is, the entire amount of the gain) to 95 percent for corporate taxpayers, the minimum holding period has been increased from 12 months to 18 months, and the transitory period for the full application of the new rules has been extended to four years. The minimum holding period for disallowing losses or computing nondeductible interest allocable to tax-exempt stock has remained unchanged. Therefore, there are situations in which the same stock may generate taxable gains or nondeductible losses and interest allocated to nonexempt stock may still be nondeductible. In the course of our analysis, we address the changes to the rules.

In Part I, we focus on the taxpayers who can benefit from the rules, the type of gains falling within the scope of the exemption, and the realization events that can trigger recognition of an exempt

gain. In Part II, we discuss requirements that must be met to obtain the exemption. In Part III, we examine special rules that apply to real estate investment companies and holding companies. In Part IV, we consider the application of the participation exemption rules in corporate contributions, mergers and acquisition, spinoffs, and stock swaps. In Part V, we briefly discuss rules that limit deductibility of costs and interest related to stock eligible for the exemption, rules that address the interaction between the participation exemption regime and some other tax regimes (namely, tax consolidation and fiscal transparency), and exemption of dividends as part of the new participation exemption system. In Part VI, we conclude.

## I. Scope of the Participation Exemption

### A. Taxpayers That Can Benefit From the Rules

The participation exemption applies to domestic companies and partnerships resident in Italy for tax purposes and organized in one of the specific legal forms referred to in the tax code and to nonresident foreign entities with a PE in Italy on gains attributable to that PE.<sup>4</sup> In more detail, the categories of taxpayers covered by the rules are:

- (1) resident domestic joint stock companies (*Società per Azioni* or S.p.A.), limited liability companies (*Società a Responsabilità Limitata*, or S.r.L.), and limited liability partnerships with capital divided by shares (*Società in Accomandita per Azioni*, or S.a.p.A.);<sup>5</sup>
- (2) resident domestic limited liability cooperative companies (*Società Cooperative a Responsabilità Limitata*, or S.c.a.r.L.) and mutual insurance companies (*Società di Mutua Assicurazione*);<sup>6</sup>

(3) resident state and private business entities;<sup>7</sup>

- (4) resident associations and consortia;<sup>8</sup>
- (5) nonresident foreign entities with a PE in Italy;<sup>9</sup>
- (6) resident domestic general partnerships (*Società in Nome Collettivo*, or SnC) and limited partnerships (*Società in Accomandita Semplice*, or SaS);<sup>10</sup>
- (7) resident domestic ship-owning companies;<sup>11</sup>
- (8) other resident nonregistered business companies (*Società di Fatto*, or SF);<sup>12</sup> and
- (9) resident sole proprietorships.

Categories (1) to (4) include domestic entities (that is, entities organized in Italy under Italian law) of a type specified therein, resident in Italy for tax purposes and treated as separate taxable entities. They are subject to corporate income tax on their worldwide income (that is, corporations in the U.S. tax sense). Category (5) includes foreign entities, that is, entities organized in a foreign country under foreign law of any legal type including corporations, partnerships, and other business entities nonresident in Italy for tax purposes that are subject to corporate income tax in Italy on income attributable to their Italian PE in Italy regardless of their legal form or tax classification in their country of organization or tax residency. Categories (6) to (8) include domestic partnerships and other entities resident in Italy that are treated as fiscally transparent entities (that is, partnerships in the U.S. tax sense).<sup>13</sup>

<sup>4</sup>Italian law classifies business entities as companies (subject to corporate income tax) or partnerships (treated as fiscally transparent) on the basis of their legal form and characteristics as determined under company/commercial law. In general, entities organized in a legal form or type with limited liability, centralized management, and unlimited life (e.g., S.p.A. or S.r.L.) are classified and treated as separate taxable entities for tax purposes (i.e., like corporations in the United States). Entities organized in a legal form or type with unlimited liability, limited life, and management generally vested on all shareholders or members of the entity (e.g., SNC and SAS) are classified and treated as flow-through entities for tax purposes (i.e., like partnerships in the United States). Foreign entities are classified and treated as separate taxable entities (i.e., corporations) for Italian tax law purposes regardless of their legal form and tax treatment under foreign law. For a review of Italy's entity classification rules, including rules that permit, with some limitations, an election to treat a company as a fiscally transparent entity, see Marco Rossi, "Italy's New Check-the-Box Rules," *Tax Notes Int'l*, July 25, 2005, p. 329.

<sup>5</sup>Tax code section 73(1)(a).

<sup>6</sup>Tax code section 73(1)(a).

<sup>7</sup>Tax code section 73(1)(b).

<sup>8</sup>Tax code section 73(2).

<sup>9</sup>Tax code section 73(1)(d).

<sup>10</sup>Tax code section 5(1).

<sup>11</sup>Tax code section 5(3)(a).

<sup>12</sup>Tax code section 5(3)(b).

<sup>13</sup>U.S. tax law distinguishes between domestic and foreign corporations based on their place of incorporation (the United States or a foreign country). Without textually using the word "resident," it treats all domestic corporations as U.S. persons and subjects them to U.S. tax on their worldwide income. (See IRC sections 11(a), (d), 881(a), 882(a), (b).) Italian tax law distinguishes between resident and nonresident (foreign or domestic) companies based on the location of their registered office, place of management, or principal place of business, and subjects resident companies to tax in Italy on their worldwide income. As a general proposition, the distinction between domestic and foreign entities based on the entity's

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A recent ruling interpreting Italy's tax consolidation rules stands for the principle that a foreign company whose legal characteristics as determined under foreign company law are substantially similar to those of a domestic company (S.p.A. or S.r.l.) that has established a local registered office in Italy through which it is managed, thereby resident in Italy for tax purposes, while retaining its charter and legal form as determined under foreign law, has access to the tax consolidation like any other domestic resident company.<sup>14</sup> Although there is no specific authority on point, by analogy the same principle should apply for the participation exemption rules.<sup>15</sup> Therefore, it seems correct to conclude that taxpayers described in items (1) to (4) above include any company resident in Italy for tax purposes that is subject to corporate income tax in Italy on a worldwide basis whether it is domestic or foreign (provided, in that case, it has a local registered office through which it is managed and is analogous to a domestic company).

Domestic tax law allows companies whose revenue falls below a minimum threshold to keep simplified books of account and excuses them from the obligation to approve an annual financial state-

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place of organization does not bear immediate consequences for determining whether a company is taxed in Italy on its worldwide income or just on its Italian-source income. The participation exemption rules are one exception to the general rule. Indeed, in the rules both domesticity and tax residency are relevant. On the face of the statute, a foreign company, even though resident in Italy for tax purposes and subject to tax in Italy on its worldwide income, is exempt from tax only on gains from sale of stock that are attributable to the company's PE in Italy.

<sup>14</sup>Private Ruling 123/E issued on Aug. 12, 2005. The rationale of the ruling is that a foreign entity that is equivalent to an Italian company for legal and tax purposes in its own country of organization that has become a resident of Italy for tax purposes by establishing its secondary office and place of management in Italy and is subject to Italian company law for the activities of its local office should be treated similarly to any other domestic resident companies for tax consolidation purposes. It eventually makes domesticity irrelevant and reinstates the general rule under which tax residency governs. The ruling rests on a comparative analysis of the foreign company's charter and legal characteristics as determined under foreign law and requires those characteristics to be sufficiently similar to those of a domestic company. In many cases, that analysis may be difficult in the absence of detailed information and a clear understanding of how foreign law exactly works. Moreover, the ruling deals with a foreign company organized in an EU state (the Netherlands). Some antidiscrimination concerns may have a played role in the analysis. Therefore, extra caution should be exercised before generalizing the principle in cases that involve foreign non-EU entities.

<sup>15</sup>Indeed, taxpayers entitled to elect for tax consolidation are described exactly in the same way as those that can benefit from the participation exemption rules.

ment. Those companies cannot benefit from the participation exemption. But if they elect to assume the ordinary accounting obligations, including the approval of an annual financial statement, they would fall within the scope of the rules for all the stock they own at the time of the shift, provided that it meets all other requirements for the exemption.<sup>16</sup>

## B. Gains Eligible for the Exemption

The rules exempt from tax gains "realized and computed in accordance with the provisions of Tax Code section 86, paragraphs 1, 2 and 3, with respect to stock or capital interest held in companies and entities referred to in Tax Code sections 73 and 5 . . . even if they are not embodied in a separate instrument."<sup>17</sup> Companies and entities referred to in tax code sections 73 and 5 are those described in Part I.A above. Therefore, exempt gains include gains realized on corporate stock as well as capital interests in partnerships and other fiscally transparent entities, whether domestic or foreign and whether resident or nonresident in Italy for tax purposes. The measure or quantity of stock or interest owned in the participated entity is not relevant for the purpose of the exemption.

Exempt gains include gains realized on securities or financial instruments characterized as equity for Italian tax purposes under tax code section 44(2)<sup>18</sup> and some contractual joint venture arrangements in which the transferor contributes only cash or cash equivalents<sup>19</sup> or a mix of cash and services. Tax code section 44(2)(a) establishes a general rule for equity-like financial instruments. Under that rule, securities and financial instruments whose remuneration consists entirely of a participation in the economic results of the debtor, an entity of the same group as the issuer's, or the transaction in which they were issued are characterized as equity for all income tax purposes. The rationale for the rule is that financial instruments that pay remuneration that resembles dividends must be treated as stock for all purposes. That implies that the remuneration is nondeductible by the borrower<sup>20</sup> and that gains realized on the

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<sup>16</sup>A clarification on this issue is provided at para. 5.2 of Circular 10/E of Mar. 16, 2005.

<sup>17</sup>Tax code section 87(1).

<sup>18</sup>Tax code section 87(3).

<sup>19</sup>Tax code section 109(9)(b) provides that these types of contractual arrangements are treated in the same way as capital interests in a company, resulting in exemption treatment of gain realized from disposition of the contract (if all other requirements are met).

<sup>20</sup>The lender includes it in income as a dividend. That means that a resident lender enjoys a partial exemption from tax (95 percent of the dividend amount for corporations and 60 percent for partnerships and individuals) that corresponds  
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instrument are exempt, much like gains on stock, if all other requirements for the participation exemption are met. It is clear from the legislative history that an instrument falls within the scope of the rule if the amount of the remuneration, and not the remuneration itself, is contingent on or determined by direct reference to the profits of the issuer (so that it represents a share of the same). The tax administration has clarified that the recharacterization rule applies only if the entire amount of the remuneration payable on the instrument consists of a participation in the economic results of the issuer. If any part of it is fixed or determined with reference to any other criteria, the instrument as a whole would be characterized as debt and any gain would not qualify for the exemption.<sup>21</sup> Opportunities to issue that type of hybrid securities increased after the reform of Italy's company law was implemented in 2003.<sup>22</sup> Tax code section 44(2)(b) would seem to operate in the opposite direction compared with the provision of tax code section 44(2)(a) and potentially limits the application of the exemption to gains on stock or other equity interests in foreign entities. It provides that stock or equity interests in foreign entities are treated as equity for Italian tax purposes only if the remuneration payable on those interests directly or indirectly involves a participa-

to taxation at a reduced effective rate (1.65 percent for a corporation and no more than 18 percent for individuals). That is the general tax treatment of dividends, whether Italian or foreign source. (See footnote 2 and Part V.F below.) For nonresident lenders, the recharacterization is generally unfavorable because dividends are subject to a higher withholding tax that is only partially reduced, but never eliminated by the Italian tax treaties. (Interest is in some situations exempt from withholding under Italian internal tax law and when taxable is subject to a withholding tax that is either more significantly reduced or totally eliminated by treaty.)

<sup>21</sup>Para. 2.2.2 of Circular 36/E, which confirmed the analysis of para. 2.3 of Circular 26/E/2004.

<sup>22</sup>A detailed description of new types of hybrid instruments that can be issued by Italian companies under the new company law provisions enacted in 2003 goes beyond the scope of this article. It may be useful to at least briefly refer to the "participating financial instruments" provided for at civil code articles 2346(6) and 2447-ter. These are instruments that can be issued in exchange for a transfer of money, other property, or services to the issuer. They do not confer full ownership rights and shareholder status as accorded to shareholders with the issuance of stock. However, they may grant the right to vote on specific matters, the right to elect an independent member of the board of directors and of the board of statutory auditors, and some economic rights, typically a yield based on the economic performance of the issuer and the right to receive back the net equity value of the contributed property. Civil code article 2411 also allows a company to issue debt obligations that provide payment of interest whose amount and accrual is determined with specific indexes, that may also refer to the economic performance of the borrower.

tion in the economic performance of the issuer. Circular 36/E/2004 clarifies at paragraph 2.2.3.5 that, for the participation exemption to apply to gains realized on instruments issued by a foreign company, they must represent an equity interest in the issuer (under corporate law principles) and must pay remuneration consisting entirely of a participation in the profits of the issuer (the "double equity" requirement).<sup>23</sup> No equity characterization would automatically result in a denial of the exemption for gains on those instruments. The exemption is, by its nature, granted only on instruments treated as stock for tax purposes. A provision included in the technical corrections bill would reinforce that concept. It also limits further the characterization of a foreign instrument as equity for tax purposes by making it contingent on the return paid on that instrument being totally nondeductible to the issuer under foreign tax law (that is, it is essentially treated as a nondeductible dividend in the issuer's residence state<sup>24</sup>). That provision, if enacted, would contrast cross-border tax arbitrage arrangements consisting of the issuance of instruments characterized as debt that generate deductible interest in the residence state of the issuer with those characterized as equity that pay tax-exempt dividends or generate tax-exempt gains in the residence state of the holder. Finally, contractual joint venture arrangements in which the transferor contributes cash (or cash and services) in exchange for a share of the profits of the transferee are also treated as stock. Any gain from the transfer of those arrangements would be eligible for the exemption.<sup>25</sup>

***The exemption is, by its nature, granted only on instruments treated as stock for tax purposes.***

The tax administration has provided clarification on how the participation exemption rules apply to: a transfer by a company of its own shares of stock held as treasury stock; a grant of an option or usufruct

<sup>23</sup>The circular does not specify whether the determination of the equity character of the instrument is to be made under Italian or foreign corporate law.

<sup>24</sup>In theory, the new provision would apply also to nondeductible interest under foreign thin capitalization rules payable on instruments that are still debt for foreign law purposes but are recharacterized as equity for Italian tax purposes under tax code section 44(2).

<sup>25</sup>For the transferor, the remuneration is treated as a dividend and enjoys the 95 percent dividends received exclusion for corporations and 60 percent dividends received exclusion for partnerships or individuals. For the transferee, the remuneration is nondeductible.

rights to shares of stock; gains on disposition of shares in mutual funds and other investment companies; and sale and repurchase agreements and securities lending transactions and lease of stock. Gains realized through the transfer of shares of stock held by a company as treasury stock, including shares of stock subject to mandatory sale, are eligible for the exemption.<sup>26</sup> Gains realized through the transfer of usufruct rights or the grant of an option on the stock by the owner of the stock would be eligible for the exemption.<sup>27</sup> Presumably (although there is no specific guidance), the gain would be equal to the difference between the fair market value of the option or usufruct rights and a proportioned amount of the adjusted tax basis of the stock. Any gain realized upon a successive transfer of the option or usufruct rights by the first transferee to a third party would not qualify. Gains from the sale of shares of mutual funds, real estate investment funds, or investment companies with variable stock (SICAV) do not qualify for the exemption because they are subject to a different and preferential tax regime.<sup>28</sup> A sale-repurchase agreement is treated like a loan of cash from purchaser to seller that is collateralized by the transferred securities. Because the seller is treated as the owner of the stock throughout the duration of the contract, a sale-repurchase agreement does not generate gains eligible for the exemption and neither does any possible transfer of the stock from the repo-buyer to third parties pending the closing of the transaction. Under Italian law, a lease of stock would be usually respected as such. That implies that the lessor would be treated as the owner of the stock throughout the term of the lease and legal title in the stock would pass to the lessee upon exercise of the purchase option at the end of the lease. At that time, the lessor may recognize a gain eligible for the exemption and the lessee would start its own holding period of the stock for participation exemption purposes. If, however, according to International Accounting Standard 17, the lease is treated as a financing transaction (that is, like a loan in which ownership and risks of loss are transferred on the lessee/borrower at the time of the contract, but the lessor/lender retains a security right in the leased/

borrowed property), the lessee would be treated as the owner of the stock. Then the holding period for participation exemption purposes would begin at the time of the contract. The transfer of the bare legal title to the stock upon exercise of the option at the end of the lease would have no tax effects. Any gain realized from the sale of the stock would be eligible for the exemption if the holding period requirement computed with reference to the first day of the contract is met.<sup>29</sup> If the shares are canceled as a result of a reduction of a company's capital, the gain is computed as the difference between the fair market value of the portion on the company's net assets corresponding to the canceled stock and the adjusted tax basis of that stock, and would fall within the scope of the exemption rules.<sup>30</sup>

### C. Recognition Events

Tax code section 87(1) refers to section 86 and provides that realization events that may cause recognition of exempt gains are: (1) a sale or exchange of stock; (2) a conversion of stock into a claim for damages for the loss of value of the stock;<sup>31</sup> (3) a current distribution of stock to shareholders; and (4) removal of stock from a trade or business. Under tax code section 9, a transfer of limited rights on the stock or a U.S. IRC section 351-like contribution of stock is treated like a sale or exchange (that is, it is a recognition event), and the amount realized is the fair market value of the right or stock transferred. For the sale or exchange, the amount of the gain is equal to the difference between the money or the fair market value of other property received (amount realized) and the taxpayer's adjusted tax basis in the stock. In distribution or removal of the stock from a trade or business, the amount realized is equal to the fair market value of the stock distributed or withdrawn. Circular 36/E/2004 extended the range of recognition events to when fiscal residency is transferred abroad (and a resident person becomes a nonresident person) by referring to the general provisions of tax code section 166.<sup>32</sup> Tax code section

<sup>26</sup>Circular 36/E/2004, para. 2.2.3.1. The legislative history confirms that conclusion. Italian company law allows a company to repurchase its own stock and keep it as treasury stock subject to some limitations. Stock held in violation of those limitations must be sold within a specified deadline. (See civil code articles 2357, 2357-bis, and 2357-ter.)

<sup>27</sup>Circular 36/E/2004, para. 2.2.3.2. In that instance, writing an option is treated as a gain recognition event. The rule appears difficult to administer because of the difficulty of appraising the value of an option.

<sup>28</sup>Circular 36/E/2004, para. 2.2.3.3.

<sup>29</sup>The tax administration has clarified the issue of the computation of the minimum holding period for stock leasing transactions in Circular 10/E/2005, para. 5.1. We discuss that issue further in Part II below.

<sup>30</sup>Tax code section 91(1)(c) and Circular 36/E/2004, para. 2.2.3.1.

<sup>31</sup>Under civil code article 2947, activities such as supervision, coordination, and management of other companies may give rise to liability for damages for loss of value of the stock of those other companies. That is a situation in which the conversion rule referred to in the text may apply.

<sup>32</sup>Under that section, if a company, a partnership, or an individual engaged in a trade or business and resident in Italy abandons Italian tax residency and becomes resident of a foreign country for tax purposes, all unrealized gains that

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87(6) provides that gains recognized by shareholders upon current distribution of cash or other property out of capital reserves of the company, as referred to under the rules of tax code section 47(5), also fall within the scope of the participation exemption.<sup>33</sup> Similarly, tax code section 87(7) provides that for distribution of cash or other property to shareholders in partial or complete liquidation of the distributing corporation, redemption of stock, or buyout of a shareholder, as referred to in tax code section 47(7), the participation exemption will apply at the same conditions set forth in the previous paragraphs (that is, if all requirements for the exemption are met) to any gain recognized by a shareholder for an amount equal to the excess of the money or fair market value of property received and the shareholder's adjusted tax basis in the stock. As a general rule, tax code section 47(7) treats any gain recognized by a shareholder upon receipt of a distribution in liquidation or redemption of stock (computed as the difference between the cash or fair market value of other property received and the shareholder's adjusted tax basis in the stock) as dividend. For corporate shareholders, 5 percent of the dividend would be taxable and 95 percent would be tax-exempt. For partnership or individual shareholders, the taxable portion of the dividend would be 40 percent, and 60 percent would be tax-exempt. Tax code section 87(7) provides that section 47(7) "dividend gain" would be treated as exempt gain under the new participation exemption rules if all other requirements for the exemption are met. The tax administration clarified that that special rule applies only to the portion of the dividend gain that is attributable to the distribution of capital reserves as opposed to earnings of the distributing company.<sup>34</sup>

exist at the time of the transfer of residency are recognized for tax purposes and are subject to tax in Italy at that time. The ECJ held that a similar, but for various reasons much more lenient, rule provided under French tax law was invalid because it violated the fundamental freedoms of the EC Treaty (ECJ, Mar. 11, 2004, C-9/02 — *Lasteyrie Du Saillant*). The ECJ's decision casts serious doubts about the continuing validity of tax code section 166.

<sup>33</sup>Tax code section 47(5) provides that for current distribution of money or other property to shareholders out of a company's capital reserves (as opposed to profits reserves), any excess of the money or fair market value of the property distributed to the shareholder and the shareholder's basis in the stock is treated as gain. Tax code section 87(6) provides that that gain may be eligible for the exemption, if all other requirements are met.

<sup>34</sup>Circular 36/E/2004, para. 5. The tax administration failed to clarify how the exempt gain portion of section 47(7) dividend gain should be calculated. An example can be used to illustrate the issue. Company A has capital reserves for 27,000x and profits reserves for 40,500x on its balance sheet and inherent gain on its appreciated assets for 7,500x, equal

(Footnote continued in next column.)

The recharacterization of section 47(7) dividend gain into a section 87(7) gain is favorable to corporate taxpayers because it reduces the effective tax burden on the dividend from 1.65 percent to zero percent. It has no tax reduction effects for partnership or individual shareholders because exempt gains and dividends are taxed alike (60 percent of the dividend or gain is taxable and 40 percent is tax-exempt). With the reduction of the exempt portion of the gain from 100 percent to 95 percent under the recent amendments to the participation exemption rules, which will be addressed specifically in other parts of this article, the recharacterization now has no tax reduction effect for corporate taxpayers. However, the recharacterization does have important substantive consequences in both cases. Indeed, gains, unlike dividends, qualify for the exemption only if specific requirements are met. If in a given case these requirements are not satisfied, the recharacterization may result in full income inclusion.

## II. Participation Exemption Requirements

Four requirements must be satisfied for the participation exemption to apply. Two refer to the shareholder, and two concern the participated company. The shareholder must have held the stock uninterrupted for 12 full months before the month in which the transfer occurred and must have carried the stock as a financial asset on its first balance sheet approved during the stock holding period. The owned company must be (fiscally) resident in a country that is not included in the special list of low-tax jurisdictions and must be engaged in the active conduct of a trade or business. For gains recognized after October 4, 2005, the holding period requirement has been increased from 12 months to 18 months. No minimum stock ownership is required. In our illustration of the requirements, we

to a total net asset value of 75,000x. Shareholder B owns 10 percent of Company A's stock with an adjusted tax basis of 2,250x. B receives 7,500x in a distribution in complete redemption of its stock and realizes a section 47(7) dividend gain of 5,250x. The dividend gain is composed as follows: (1) 450x as excess of B's share of A's capital reserves (10 percent of 27,000x, or 2,700x) over B's adjusted tax basis in its stock (2,250x); (2) 4,050x as B's share of A's profits reserves (10 percent of 40,500x); and (3) 750x as B's share of A's assets' built-in gain (10 percent of 7,500x). The amount of the 87(7) exempt gain can be calculated, alternatively, as follows: 450x (item 1); 1,200x (items 1+2); 2,100x (*i.e.*, a portion of the dividend gain that bears the same ratio as the capital reserves over the sum of the capital and profits reserves of the company —  $27,000x/67,500x = 40$  percent); or 1,890x (*i.e.*, a portion of the dividend gain that bears the same ratio as the capital reserves over the total net asset value of A —  $27,000x/75,000x = 36$  percent).

often use the terms selling or transferring shareholder, transfer or sale, and transferred stock for convenience of discussion. It should be clear that the rules apply to gains recognized as a result of realization events other than a sale or transfer of the stock.

### A. Minimum Holding Period Requirement

Tax code section 87(1)(a) requires that the selling shareholder has held the transferred stock without interruption for a period running from the first day of the 12th month preceding the month of the transfer. The tax administration has clarified that the minimum holding period refers to a period of 12 full months preceding the month of the sale and is not equivalent to 365 days. In some cases, stock owned for more than 365 days may fail the test, while stock held for a shorter period of time may qualify.<sup>35</sup> If stock has been acquired in several different but integrated transactions as part of an overall plan, the calculation of the holding period of the transferred stock is made by considering the stock acquired last as sold first (last-in, first-out rule). The tax administration has clarified that the last in, first out rule applies only for computing the holding period of the transferred stock, but does not affect the application of the ordinary rules for computing the tax basis in the transferred stock to calculate the amount of gain realized.<sup>36</sup> Even if the participated company has been in existence for less than one year, the minimum holding period must

<sup>35</sup>Indeed, that may be a trap for the unwary. Stock purchased on May 2, 2003, and sold on May 31, 2004, does not qualify, even if held for 395 days. Stock purchased on May 1, 2004, and sold on May 2, 2005, does qualify, even though held for 367 days.

<sup>36</sup>An example can be used to illustrate that point. A purchased 1,000 shares of stock of company B in three different steps as part of one integrated transaction: 250 on Oct. 5, 2001, at a price of 1,000x; 400 on Mar. 10, 2002, at 1,500x; and 350 on June 10, 2003, at 1,800x, for a total price of 4,300x, or 4.3x per share. A uses the average cost method to determine its adjusted tax basis in the purchased stock. A sells all of its B stock on July 5, 2004, for 6,300x. Because all the transferred stock has been held for the minimum required period, the entire gain (2,000x) satisfies the test. Alternatively, A sells all of the stock on June 25, 2004. The last portion of 350 shares (or 35 percent of the transferred stock) purchased on June 10, 2003, does not satisfy the minimum holding period requirement. Therefore, 35 percent of the total gain (or 700x) does not qualify for the exemption. Alternatively, on June 10, 2004, A sells 500 shares (or 50 percent of its stock of B) for 3,150x. On the basis of the last-in, first-out rule, 350 shares (or 70 percent of the total number of shares sold) do not satisfy the minimum holding period requirement, while 150 (or 30 percent of the total number of shares sold) do. Therefore, 30 percent of the total gain realized (or 300) meets the test and may qualify for the exemption, while 70 percent (or 700x) is taxable.

satisfied. There is no relaxation of the requirement for a newly formed company.

Whether the minimum holding period requirement is met is determined at the time of the transfer. That is usually when ownership passes to the buyer or the transfer produces its legal effects and actually takes place (as opposed to when a binding contract is signed). Some problems may arise for free issuance of stock to existing shareholders holding an option to purchase new stock included in their old stock, purchase of shares through the exercise of a separate option to acquire stock, and purchase of shares through the exercise of a conversion right by the holders of convertible or exchangeable debt obligations. For stock issued to existing shareholders not contributing additional money or property in exchange for the newly issued stock under an option embedded in their old stock, the holding period of the newly issued stock is tacked to the holding period of the old stock in the hands of the shareholders. For new stock issued to an existing shareholder in exchange for contribution of money or property to the issuing corporation, the holding period for the newly issued stock begins on the date of issuance of the new stock. For purchase of stock through the exercise of an option (whether separate or part of preowned stock), the holding period for the newly purchased stock begins on the date of the purchase of the option (as opposed to the date of exercise of the option). That contrasts with the purchase of stock through the conversion of an obligation, for which the holding period begins from the date of the conversion.<sup>37</sup>

### **Four requirements must be satisfied for the participation exemption to apply.**

Law Decree 203 of September 30, 2005, increased the minimum holding period to 18 months. The new holding period applies to gains realized after October 4, 2005.

### B. Nonportfolio Income Requirement

Tax code section 87(1)(b) provides that, to be eligible for the exemption, the stock must be booked

<sup>37</sup>Those rules stem from a series of older administrative notices and rulings that dealt with the calculation of the holding period of stock for deferring recognition of gain under the predecessor of tax code section 86. The tax administration in Circular 36/E has considered that valid guidance for computing the stock holding period under the new participation exemption rules. They include Circulars 14 of Apr. 11, 1991 (para. 3); 22 of Oct. 22, 1990 (para. 3.2); 16 of May 10, 1985; and 73/E of May 27, 1994 (para. 3.16).

as financial assets on the shareholder's first balance sheet approved during the holding period. The stock is "tainted" as a result of its initial booking, and subsequent different classifications in the balance sheet are irrelevant. Therefore, stock that was booked as a financial asset at the time of purchase and is booked as a current asset at the time of the sale may still generate gains eligible for the exemption, while stock booked as a financial asset at the time of the sale but booked as a current asset on the first balance sheet after the purchase generates only taxable gains. The way the stock is carried on the shareholder's balance sheet should reflect the economic nature of the investment. Financial assets represent long-term, strategic investments, while current assets represent short-term, speculative portfolio investments.<sup>38</sup> Therefore, the balance sheet requirement implements a more substantive requirement under which stock eligible for the exemption must represent a nonportfolio investment. For stock already owned at the time of the enactment of the new participation exemption rules, reference is made to the classification of stock in the balance sheet relating to the second taxable year preceding the effective date of the rules (January 1, 2004). However, for stock acquired during the tax year immediately preceding the effective date of the rules, reference is made to the balance sheet for the same year.<sup>39</sup> For shares partly classified as financial assets and partly classified as current assets, some problems may arise in the computation of the gain eligible for the exemption. The tax administration has clarified that the last-in, first-out rule applies on an aggregate basis, and not separately class by class, and that shares moved from financial asset to current asset classification retain their original acquisition date for the purpose of the rule.<sup>40</sup> The

<sup>38</sup>Civil code articles 2424-*bis* and 2426 provide rules on booking assets on an owner's balance sheet depending on whether they are long-term, strategic investments (they must be included in the class of financial assets) or short-term portfolio investments (they must be included in the class of current assets).

<sup>39</sup>For calendar year taxpayers, it means that stock owned as of Jan. 1, 2004 (effective date), is deemed to satisfy the requirement if it was booked as financial assets on the financial statement of the year ending on Dec. 31, 2002. If it was stock acquired during 2003, the requirement is satisfied if the stock is booked as a financial asset in the financial statement for the period ending on Dec. 31, 2003.

<sup>40</sup>Circular 36/E/2004 uses an example to illustrate the application of the rule. Company A owns 100 shares of stock acquired on Mar. 31, 2002, at a price of 120 booked in the financial asset class, 20 shares of stock acquired on Oct. 31, 2004, at a price of 30 booked in the current asset class, and moved 10 shares of stock from the financial asset to the

nonportfolio requirement makes the tax treatment of the gain entirely dependent on the way in which the transferred stock is carried on the taxpayer's balance sheet. That is a taxpayer's choice that may be manipulated to achieve the desired tax result.<sup>41</sup> To avoid that risk, the antiavoidance provisions of article 37-*bis* of Presidential Decree 600 of 1973 have been amended by adding the balance sheet classification as one of the transactions for which the tax administration can disregard the form and look at the substance of the matter if they lack economic reality or good business purposes and appear to have been designed solely for the purpose of avoiding taxes. Under that rule, the tax administration is authorized to disregard the way the stock is carried on the taxpayer's financial statement and deny the application of the exemption if, in reality, the stock does not represent a long-term strategic investment.

### C. Fiscal Residency Requirement

Tax code section 87(1)(c) provides that for the exemption to apply, the participated entity must be resident in a country that is not on the list of the low-tax jurisdictions approved by the Ministerial Decree of November 21, 2001, as subsequently amended.<sup>42</sup> Residency of the entity is determined under Italian tax law rules.<sup>43</sup> To avoid a last-minute change of tax residency of the participated entity solely for the purpose of qualifying for the exemption, the participated entity must have been resident in a nonblacklisted jurisdiction without interruption starting on the first date of the third tax

current asset category on Dec. 31, 2004. Company A uses the average cost-price method to determine its basis in the stock. Therefore, as of Dec. 31, 2004, the 30 shares booked in the current assets category have an average cost price of 1.4 each. On Apr. 30, 2005, Company A sells 10 shares at a price of 17. According to the last-in, first-out rule, the 10 shares are deemed to belong to the current asset shares. The gain realized is 3. That gain is taxable because the 10 shares sold are deemed to be 10 of the 20 shares last acquired on Oct. 31, 2004. The rebooking of 10 shares of the 100 shares acquired on Mar. 31, 2002, and initially booked in the financial assets category (therefore satisfying the test), is disregarded.

<sup>41</sup>Company law principles require that the financial statement truly reflect the real substance of a company's business. However, that principle does not have the effect of rendering the financial statement classification of the stock irrelevant for tax purposes. It is not sufficient to assure compliance with and effective enforcement of the nonportfolio investment requirement.

<sup>42</sup>The list was revised and updated in ministerial decrees on Mar. 22, 2002, and Dec. 27, 2002.

<sup>43</sup>Italian tax law determines the tax residence of corporations or partnerships with reference to the place of the entity's registered office, management, or principal business.

(Footnote continued in next column.)

year preceding the transfer of stock and ending on the date of the transfer (testing period).<sup>44</sup> If the participated entity was formed less than three full tax years before the year of the transfer, the testing period is the entire period in which the entity has been in existence. The person who owned the stock during the testing period and how the stock was acquired by the taxpayer claiming the exemption are irrelevant for the purpose of the residency requirement. For gains on sale or disposition of participating financial instruments treated as stock for tax purposes, the residency requirement must be tested for both the issuer of the instrument and the entity to whose profits the remuneration paid on the instruments is connected. Even if the entity is resident in a blacklisted jurisdiction and fails the residency test, the taxpayer can still qualify for the exemption if it demonstrates that by channeling the investment through the blacklisted entity it has not obtained the result of earning income in a low-tax jurisdiction. As clarified by the tax administration, this means that the taxpayer must prove that at least 75 percent of income earned by the participated entity is from sources in a nonblacklisted jurisdiction and has been subject to tax there according to the ordinary rules of the source country.<sup>45</sup> To provide that evidence, the taxpayer must obtain a favorable ruling from the tax administration<sup>46</sup> and

<sup>44</sup>Tax code section 87(2). The requirement applies regardless of the person who owned the stock during the testing period.

<sup>45</sup>Neither the statute nor the administrative guidance clarifies how the source of income is determined for that purpose. One may guess that source of income (like residence) is to be determined under Italian tax law principles. However, that may be a too easy (and reasonable) guess. In one published ruling, the tax administration took the position that dividend income received from an entity established in a nonblacklisted jurisdiction does not qualify for the 75 percent test because dividends are sourced based on the residence of the payee (in that case, the blacklisted entity) with no further inquiry on how the dividends may have been taxed in the country of the payer (that is, possible application of withholding tax) or how the profits from which dividends were paid may have been paid in that country (that is, possible application of ordinary corporate income tax there). The general rule under Italian tax law is that dividends are sourced in the payer's residence state (tax code section 23). Also, the statute and the administrative guidance fail to clarify whether the term "income" means gross or net income. A typical situation in which the 75 percent rule would apply is when the blacklisted entity operates through a branch in a nonblacklisted jurisdiction and earns income through that branch. If income attributable to the branch is subject to ordinary income tax in that jurisdiction and amounts to 75 percent or more of the entity's total income, the test is met.

<sup>46</sup>The ruling procedure is the same as that applied to obtain the disapplication of the controlled foreign companies rules governed by tax code section 165(5)(b).

cannot simply prove its case directly in court. Without a favorable ruling, the exception to the residence requirement does not apply.<sup>47</sup> Like the residency requirement, the 75 percent test must be satisfied continuously for a period beginning on the first day of the third tax year before the transfer and the date of the transfer.<sup>48</sup> The rationale of the residency requirement (and of the 75 percent exception to the requirement) is that a gain is exempt from tax only if the profits that are reflected in the gain have been subject to tax at the entity level, either in the entity's state of residence or in a third country in which they have been earned.

#### D. Active Trade or Business Requirement

Tax code section 87(1)(d) provides that to benefit from the exemption, the participated company must be engaged in the active conduct of a trade or business within the meaning of tax code section 55.<sup>49</sup> Like the residency requirement, the active trade or business requirement must be met for a continuous period of three full tax years before the year of the transfer or for the full period in which the participated entity has been in existence (if formed less than three full tax years before the transfer), regardless of who owned the stock in that entity and how the stock was acquired by the taxpayer seeking the exemption. The active trade or business requirement is always deemed to be satisfied for publicly traded stock or stock sold through a regulated public sale offer. In contrast, the requirement is always presumed (nonrebuttably) not to be satisfied for stock of passive real estate investment companies. The special real estate companies rule is discussed in Part III.A below. The statute provides special rules on the application of the residency and active trade or business requirement for stock owned through holding companies. Those rules are based on a look-through approach, under which the two tests apply at the level of the lower-tier operating companies. They are met if they are satisfied for lower-tier operating companies that represent more than 50 percent of the value of the holding company. The holding company rules are discussed in Part III.B below.

<sup>47</sup>The 75 percent rule is one of the two exceptions to the application of the CFC rules. The second exception, based on whether the CFC is engaged in an active trade or business in the state in which it is organized, does not apply for the participation exemption rules.

<sup>48</sup>Circular 26/E/2004, para. 2.3.3.

<sup>49</sup>Reference is made to the tax concept of trade or business, which is wider in scope than the civil law concept of trade or business set out in civil code article 2195. In that case, because the existence of a trade or business is required to benefit from a tax exemption, the use of the wider concept of trade or business is favorable to taxpayers.

### III. Real Estate and Holding Companies

#### A. Real Estate Investment Companies Exclusion

Tax code section 87(1)(d) provides that the active business requirement is presumed not to be met, without possibility of proof to the contrary, for stock in companies when more than 50 percent of the assets are represented by real estate assets other than those held for sale to customers in the ordinary course of the company's business (inventory) or those that are used in the company's trade or business. It appears from the statutory definition that disqualified assets are real estate property held for purely investment purposes, while nondisqualified assets are real estate property held as stock-in-trade or inventory of a real estate dealer or trader and those used in the active conduct of a real estate business. Therefore, the denial of the exemption is aimed at companies engaged in passive real estate investment activity.<sup>50</sup> But it does not apply to real estate dealers or companies engaged in real estate management activities.<sup>51</sup> Tax code section 87(1)(d) expressly singles out from disqualified properties real estate assets held by financial leasing companies that are leased under a financial lease contract to customers. The rationale of the provision is that a

<sup>50</sup>*I.e.*, companies that own real estate properties leased under long-term net leases with substantially all management activities carried out by the tenant. Companies that operate as real estate dealers or engage in real estate management activities either directly or through an agent are out of the scope of the exemption. The distinction corresponds to the test used under U.S. tax law to distinguish between foreign persons engaged in a real estate trade or business in the United States as a result of real estate management activities conducted in the United States, either directly or through an (dependent or independent) agent, who are taxable in the United States on a net income basis on income effectively connected with their real estate business (*Inez De Amodio*, 34 T.C. 894 (1960), *aff'd* 229 F.2d 623 (3rd Cir. 1962); *Jan Casimir Lewenhaupt*, 20 T.C. 15 (1953), *aff'd* 221 F.2d 227 (C.A. 9 1955)), and foreign persons that do not conduct those activities and therefore are not so engaged (*Evelyn M. L. Neil*, 46 B.T.A. 197 (1942); *Elizabeth Herbert*, 30 T.C. 26 (1958)) but are subject to withholding tax on the gross amount or their operating rental income.

<sup>51</sup>The exclusion from the exception to the participation exemption for companies that use real estate assets in the active conduct of a real estate business has been confirmed in a colloquium on the Senate floor (no. 5-03920, February 2005) during which the deputy minister of the economy and finance discussed the case of a company that owns and manages a commercial building and leases commercial spaces in the building, also selling related services to its tenants. The deputy minister confirmed that the commercial building is qualified property because, even though it is leased to third parties, the leases are not passive investment contracts, but part of an active real estate managing activity.

real estate financial leasing business is similar to a real estate dealer's activity and should be treated in the same way. The tax administration has clarified that for mixed-use assets, 50 percent of the value of the assets goes into the disqualified group while the remaining 50 percent goes into the qualified group.<sup>52</sup> Finally, the tax administration took the position that if a taxpayer that is in the business of constructing and/or buying and selling real estate consistently leases its real estate property under long-term net lease arrangements while waiting for opportunities to sell the property on the market, so that its business actually changes from that of a dealer into a passive real estate investment activity, the real estate property becomes disqualified property.<sup>53</sup>

The formula to apply the real estate investment company exclusion is real estate investment assets divided by total assets. The result must exceed 50 percent. The technical explanation of the law enacting the tax reforms clarified that the computation is to be made with reference to the assets' fair market value and the denominator of the formula includes built-in gains and unstated goodwill. Circular 36/E/2004 points out that assets are computed on a gross value basis. However, it also states that both components of the formula must be considered by taking into account any possible elements that may affect positively or negatively the actual value of the assets, like debts or mortgages encumbering the property. Therefore, it would seem correct to conclude that the computation must be made on a net asset value basis.

#### B. Holding Company Rules

For stock of holding companies, the rules take a look-through approach and provide that the residency and active trade or business requirements are tested at the level of the lower-tier operating subsidiaries. However, that approach is limited. The rules provide a safe harbor and establish that the two requirements are deemed to be satisfied if more than 50 percent of the value of the assets of the holding company is stock of operating subsidiaries that satisfies the two requirements.<sup>54</sup> Once the 50 percent safe harbor is met, the holding company is treated as a discreet entity. A gain from the sale of stock of the holding company would qualify for the exemption, including for the portion attributable to the value of the operating subsidiaries that do not

<sup>52</sup>Circular 10/E of Mar. 16, 2005, para. 5.3.

<sup>53</sup>Ruling 152/E issued on Dec. 15, 2004.

<sup>54</sup>Tax code section 87(5).

meet the requirements.<sup>55</sup> Instead, the rules take an entirely separate entity approach on the minimum holding period and nonportfolio investment requirements, which apply at the level of the holding company without regard to the period of time during which the stock in the operating subsidiaries has been held and the nature of the investment in that stock. Therefore, a gain from the sale of stock of a holding company would qualify for the exemption also for the portion of the gain attributable to the stock of operating subsidiaries held by the holding company for less than the required period and purchased as a portfolio investment rather than a strategic acquisition. As a result of the look-through/50 percent safe harbor and the separate entity rule, a holding company may be a powerful tax planning tool to work around or accommodate the requirements for the participation exemption and obtain an exemption that would otherwise not be available if the stock of the operating companies had been held directly.<sup>56</sup> At the same time, as the

<sup>55</sup>In other words, the look-through approach is adopted only to test the requirements at the level of the operating companies. Once tested, and if satisfied under the 50 percent safe harbor, the rules go back to a separate entity treatment. In some situations, the approach taken by the rules may lead to unfair results, unfavorable to taxpayers. An example can illustrate the case. Holding company A owns stock of companies B, C, and D. C and D represent more than 50 percent of the value of A and do not meet the residency/active business requirements. C and D stock have built-in losses, but B stock has built-in gain exceeding those losses so that A stock is appreciated stock and is sold at a gain. However, A does not qualify for the safe harbor because C and D do not meet the residency/active business requirements and represent more than 50 percent of the value of A. Therefore, a sale of A stock would trigger a taxable gain even if the gain is entirely attributable to stock (B stock) that would qualify for the exemption if held and disposed of directly by A's shareholders. The losses on the stock of C and D (that result in a reduced amount of gain from the sale of A stock) would not be recognized (while they would have been recognized if C and D stock had been held and disposed of directly by the shareholders of A). An alternative and probably more correct look-through approach could be that of treating the sale of stock of a holding company as an indirect pro rata sale of the stock of operating subsidiaries owned by the holding company and characterizing and computing the gain accordingly. That approach would probably be conceptually more satisfying and lead to more correct results.

<sup>56</sup>That is generally valid for the acquisition of subsidiaries that are not already owned through a commonly controlled structure or are not part of the same group. An example can illustrate the point. Shareholder X has owned the stock of holding company Y from time immemorial as a nonportfolio holding company. X wants to acquire stock of companies A, B, C, D, and E as portfolio investments because he thinks that they have the potential for quick appreciation and will generate a significant gain in a relatively short period of time. Those companies have the same net asset value. D and E

(Footnote continued in next column.)

example discussed in footnote 55 illustrates, the holding company rule may also be a trap for the unwary and generate unfortunate results for ill-advised taxpayers.

***The denial of the exemption is aimed at companies engaged in passive real estate investment activity.***

A holding company is defined as a company whose activity of holding stock of other companies is exclusive or "prevalent" compared with any other business activities of the company. The holding activity is "prevalent" if more than 50 percent of company's assets are financial assets defined in section 106(1) of Unified Code of Banking Laws (shares of stock in other companies) and if more than 50 percent of company's gross income is income generated by the above-mentioned assets (dividends or gains), currency exchange transactions, or commission fees from transactions referred to in section 106(1) of Unified Code of Banking Laws. The tax administration has clarified that if a company has acquired the status of holding company (as defined above) less than three full tax years before the year of the transfer of the stock (the testing period), a mixed approach must be adopted. For the period during the testing period in which the company was a holding company, the residency and active business requirements are tested at the level of the operating subsidiaries under the look-through/50 percent rule. For the period during the testing period in which the company was not

reside in a blacklisted jurisdiction or are not engaged in a trade or business; thus a sale of stock in D and E would trigger a taxable gain. Moreover, if X acquired stock of those companies directly, a disposition of any of the stock of A and B before 12 full months before the month of the transfer would trigger a taxable gain. Therefore, X directs its holding company Y to acquire the stock of A, B, C, D, and E. Soon thereafter X disposes of the stock of Y at a gain, entirely attributable to the appreciation in value of A, B, C, D, and E. The gain would be wholly exempt under the participation exemption rules because Y's stock satisfies the minimum holding and nonportfolio investment requirements (tested at the level of Y) and the residency and active trade or business requirements (tested at the level of A, B, C, D, and E on an aggregate basis and under the 50 percent safe harbor). When the operating subsidiaries are part of the same group, the extent to which the movement of stock of the subsidiaries under the umbrella of a holding company can help take advantage of the participation exemption rules. The transactional costs and administrative complexity of that strategy must be tested against the provisions on the application of the participation exemption requirements for corporate mergers and acquisitions and would depend on the specific facts and circumstances of each particular case.

a holding company, the residency requirements are tested at the level of the company itself according to the ordinary rules.<sup>57</sup>

For the 50 percent rule, reference must be made to the fair market value of the company's assets. The safe harbor is met if more than 50 percent of the fair market value of the company's assets is stock of operating companies that satisfy the residence and active business requirements. For example, company A owns stock of holding company B that, in turn, owns stock of companies C, D, and E. They represent more than 50 percent of the total value of B. B also owns company G, which is a controlled foreign corporation, and company F, which is a real estate investment company. A's gain from the sale of B's stock would qualify for the exemption (if the minimum holding period and nonportfolio investment requirements are satisfied for B) and for the portion attributable to the value of G and F (whose stock, if owned directly, would not qualify for the exemption). The application of the holding company rules gets more complicated for subholding structures or mixed-holding companies (that is, holding companies that are also engaged in the direct conduct of separate business activities).

For multiple-tier structures with intermediate and top-tier holding companies, the residency and active business requirements must be tested, taking into account the stock of operating subsidiaries owned by the upper-tier holding company through lower-tier subholding companies. In other words, the look-through rule applies to all subholding companies at each level of the chain. The computation includes the stock of all operating subsidiaries indirectly owned through intermediate holding companies by the holding company that is being tested. Therefore, if A owns 100 percent of the stock of holding company B, which owns 100 percent of stock of operating companies C and D and subholding company E, which in turn owns 100 percent of stock of operating companies F and G, B is deemed to meet the residency and active business requirements if more than 50 percent of the value of its assets, including the value of stock of E reflecting the value of F and G, is stock of companies that satisfy the requirements. The stock of C and D owned directly, and of F and G owned indirectly, through the intermediate holding E enter into computation. The tax administration confirmed that interpretation of the rules and illustrated it with two examples.<sup>58</sup> In the first example, holding company H owns: (1) stock valued at 180,000x (18 percent of the total asset value of H) in A, which is resident in a blacklisted jurisdiction (and therefore does not qualify for the exemption); (2)

stock valued at 390,000x (39 percent of the total asset value of H) in B, which is resident in Italy and is engaged in a trade or business (and therefore qualifies for the exemption); and (3) stock valued at 430,000x (43 percent of the total assets value of H) in subholding SH. Subholding company SH owns: (1) stock valued at 163,000x (38 percent of the total assets value of SH and 16 percent of the total asset value of H) in C, which does not carry out a trade or business (and therefore does not qualify for the exemption); and (2) stock valued at 267,000x (62 percent of the total asset value of SH and 27 percent of the total assets value of H) in D, which is engaged in trade or business and is resident in Italy (and therefore qualifies for the exemption). Stock of H is eligible for the exemption (if the other requirements to be tested at the level of shareholder A are satisfied) because the residency and active business requirements are met for operating companies directly and indirectly owned by H that represent 66 percent of the total asset value of H (B — 39 percent, and D — 27 percent). In the second example, the facts are the same as in the first except that B is resident in a blacklisted jurisdiction and therefore does not qualify for the exemption, and A is resident in Italy and is engaged in a trade or business (and therefore qualifies for the exemption). In that case, stock of H is not eligible for the exemption because the residency and active business requirements are met for operating companies that represent only 44 percent of the total asset value of H.

**For so-called mixed holding companies, the assets of the trade or business also must be considered to determine whether the requirements are met.**

For so-called mixed holding companies, that is, companies engaged in that a trade or business in addition to the activity or holding stock of other companies,<sup>59</sup> the assets of the trade or business also must be considered to determine whether the requirements are met. The tax administration illustrates the rule with an example.<sup>60</sup> Holding company B has business assets valued at 400,000x (40 percent of its total assets) and owns: (1) stock valued at

<sup>57</sup>Circular 10/E of Mar. 16, 2005, para. 5.4.

<sup>58</sup>Circular 36/E/2004, para. 2.3.5, examples 10 and 11.

<sup>59</sup>In any event, the stock holding activity must be prevalent compared to the trade or business; otherwise the company would not qualify as a holding company. Then the special holding company rules would not apply and the requirements would be tested separately at the level of the company according to the ordinary rules. To be prevalent, the fair market value of stock owned by the company must be more than 50 percent of the total asset value of the company.

<sup>60</sup>Circular 36/E/2004, para. 2.3.5, example 12.

300,000x (30 percent of its total assets) in A, a company resident in a black-listed jurisdiction (that does not qualify for the exemption); (2) stock valued at 160,000x (16 percent of its total assets) in B, a company resident in Italy and engaged in a trade or business (that qualifies for the exemption); and (3) stock valued at 140,000x (14 percent of its total assets) in subholding SH. SH owns stock valued at 41,000x (4 percent of the total asset value of H) in C, a real estate investment company (that does qualify for the exemption) and stock valued at 99,000x (10 percent of the total asset value of H) in D, a company resident in a blacklisted jurisdiction (that does not qualify for the exemption). Stock of H qualifies for the exemption (provided that the other requirements to be tested at the level of H are also satisfied) because 56 percent of its assets (40 percent business assets and 16 percent stock of B), including the business assets it holds directly, is represented by assets used in a trade or business. That result appears to be a departure from a strict application of the holding company rules. The presence of business assets changes the analysis. It qualifies the stock of H, which otherwise, on the basis of the look-through rule applied to the stock of the operating subsidiaries, would not qualify. The mixed holding company rule results in the taxpayer's ability to use a holding company to take advantage of the participation exemption rule. If a holding company is not sufficient to enable the taxpayer to qualify for the exemption, by injecting business assets into the holding company and converting it into a mixed holding company, the taxpayer can completely change the result of the analysis and get access to the exemption.

#### IV. Contributions, M&As, Spinoffs, And Stock Swaps

Italian tax law provides limited nonrecognition treatment for corporate mergers, acquisitions, and buyouts. The general principle in that context is that stock received by the acquired company's shareholders in a transaction that qualifies for nonrecognition treatment and whose adjusted tax basis in the hands of the acquired company's shareholders is determined with reference to the adjusted tax basis that they had in the stock surrendered (that is, it is an exchanged or substituted basis) has a holding period that includes the holding period of the stock surrendered (tacking period) and keeps the original balance sheet classification as that of the stock surrendered (that is, it is a financial asset to the same extent as the stock surrendered). Similarly, stock acquired in a transaction qualifying for nonrecognition treatment with an adjusted tax basis in the hands of the acquiring company that is equal to the transferring shareholder's adjusted tax basis in that stock (that is, a transferred or carryover basis)

has a holding period that includes the holding period of the stock in the hands of the transferring shareholder and keeps the original balance sheet classification that it had in the hands of the transferring shareholder. We test below the way those general principles apply in some nonrecognition transactions provided in the Italian Tax Code.

#### A. Contribution of Ongoing Business or Controlling Stock

Tax code section 176 provides that if a resident person contributes an ongoing business to a resident company solely in exchange for stock of the transferee company, no gain or loss is recognized on the contribution of the assets of the business. The transferor takes a substituted basis in the stock received in the exchange and the transferee company takes a carryover basis in the transferred assets. Therefore, recognition of gain is deferred until a subsequent taxable transfer of the stock or the assets. Under tax code section 176(2), the parties to the transaction can opt out of nonrecognition treatment. Therefore, nonrecognition treatment is actually elective.<sup>61</sup> Similarly, tax code section 175 provides that for contribution of an ongoing business or controlling stock<sup>62</sup> to a company solely for stock of the transferee company, the amount realized by the transferor is deemed to be the book value of the stock received in the exchange as reported on the balance sheet of the transferor, or the book value of the transferred assets or stock as reported on the balance sheet of the transferee, whichever is higher. Any gain or loss is equal to the difference between the amount realized, defined as above, and the adjusted tax basis in the transferred assets or stock. If the transferred business is a trade or business located in Italy, that provision also applies to transactions in which the transferor or the transferee are nonresident persons. Tax code section 175 is sometimes considered to be a recognition rule, although nothing in the provision necessarily implies that

<sup>61</sup>The parties may want to elect recognition treatment either because the transferor wants to recognize a loss on the transferred business or because the transferee wants a cost basis in the transferred assets.

<sup>62</sup>Controlling stock includes stock that gives control over the subsidiary company within the meaning of civil code article 2359 (with control meaning more than 50 percent of the voting power or sufficient voting power to exercise a dominant influence over the participating company or ability to exercise a dominant influence as a result of another contractual relationship) or confers to a stockholder the capacity to exercise a significant influence over the subsidiary company (which is presumed for stock holding at least 20 percent or 10 percent of the voting power, depending on whether the subsidiary is a private or publicly traded company).

gain or loss will be recognized. (Quite to the contrary, if book and tax basis correspond and are preserved after the transfer, no gain would be recognized.)<sup>63</sup>

Tax code section 176(4) provides that stock received in the exchange replaces the transferred assets or stock as a financial asset on the transferor's balance sheet. On the basis of that provision, the tax administration has taken the position that stock received in the nonrecognition exchange inherits the balance sheet classification and holding period of the transferred stock or assets as in the hands of the transferor before the transfer. These are substituted for the holding period and balance sheet classification of the stock issued to the transferor for the purpose of the holding period and nonportfolio investment requirements of section 87(1)(a) and (b)<sup>64</sup> on that stock. Therefore, the transferor would take a substituted holding period and balance sheet classification in the stock received in the exchange; that is, it would exchange the holding period and balance sheet classification of the contributed stock to the holding period and balance sheet classification of the stock received in the transaction.

***A taxable gain from sale of the assets can be converted into a tax-exempt gain from sale of stock whose value reflects the value of the assets.***

Tax code section 176(1) provides that the transferee succeeds in the tax position of the transferor for all assets and liabilities of the contributed business. Tax code section 176(4) provides that an ongoing business transferred in a nonrecognition 176 transaction is deemed to be held by the transferee for a period that includes the holding period of the transferor (tacking period). As a result, the transferee would take a carryover holding period and

balance sheet classification in any stock that is part of the business acquired in the transaction. The tax administration has clarified that the transferor's holding period and balance sheet classification of the stock before the transfer carry over to the transferee after the transfer.<sup>65</sup> For taxable contribution of stock or assets, the holding period of the stock received in the exchange would be a fresh holding period beginning on the date of the exchange. The recipient of the stock would be free to book it on its balance sheet regardless of the way in which the stock received or the stock or assets transferred had been booked before the transaction (that is, no substituted carry-over holding period and balance sheet classification would apply). On the effect of the transaction on residency and active business requirements tested at the level of the participated company, Circular 36/E/2004 provided specific clarifications for mergers and spinoffs. Those clarifications can be extended also to sections 175-176 transactions and are discussed in Part IV.B below.

With nontaxable sections 175-176 transactions, taxpayers can contribute appreciated business assets to a newly formed or preexisting company in exchange for stock of the company that inherits the holding period and balance sheet classification of the transferred assets and can sell the stock without recognition of gain under the participation exemption rules. Therefore, a taxable gain from sale of the assets can be converted into a tax-exempt gain from sale of stock whose value reflects the value of the assets. Tax code section 176(3) provides that the use of that type of transaction solely to convert a taxable asset gain into a tax-exempt stock gain is legitimate and would not be subject to the antiavoidance provisions of article 37-*bis* of Presidential Decree 600 of 1973.

## **B. Mergers**

Under tax code section 172, in a merger, the acquired company's shareholders do not recognize gain on the exchange of their stock of the acquired company for stock of the acquiring company. The acquired company does not recognize gain on the transfer of its assets to the acquiring company in the merger. And the acquiring company does not recognize gain on issuance of its stock to the acquired company's shareholders. Gain recognition is deferred through exchange/transferred basis rules. The target's shareholders take an exchanged or substituted basis in the stock of the acquiring company they received in the exchange and the acquiring company takes a transferred or carryover basis

<sup>63</sup>Indeed, tax code section 175(2) provides that the book rule of 175(1) does not apply and the amount realized is determined with reference to the fair market value of the contributed assets for contribution of stock that does not qualify for the exemption in exchange for stock that would qualify for the exemption in the hands of the transferee but for the residency requirement. The rationale of the provision is to avoid an exchange of nonqualifying stock for qualifying stock without recognition of gain. That rule indirectly, but clearly, confirms that a section 175 transaction can be tax-free if the proper conditions exist. A more detailed discussion of the interaction between those two provisions and the operative rules of sections 175 and 176 is beyond the scope of this article.

<sup>64</sup>Circular 36/E/2004, para. 2.3.6.1.1. and para. 2.3.6.2.

<sup>65</sup>Circular 36/E/2004, para. 2.3.6.2.

in the assets acquired in the merger.<sup>66</sup> The acquiring company can book the assets in its balance sheet with no recognition of gain for tax purposes. For purposes of participation exemption requirements, the target shareholders take a transferred or substituted holding period and balance sheet classification in the acquiring company's stock that they received in exchange for their target's stock. The acquiring company takes a transferred or carryover holding period and balance sheet classification in any stock acquired in the merger.<sup>67</sup> The conclusions are the same as those that apply for sections 175-176 tax-free contributions.

**Losses from disposition of stock that qualifies for the exemption are nondeductible.**

For the residency and active business requirements, the tax administration has clarified that they must be tested for both the merging and acquiring company, and require a comparative analysis of the acquiring company's historic assets (that is, assets owned before the merger) and target's assets acquired in the merger. If more than 50 percent (by net fair market value terms) of all assets owned by the acquiring company after the merger are assets that have been used in the conduct of a trade or business or owned by a company that has been resident in a nonblacklisted jurisdiction for three consecutive tax years before the year of a transfer of the acquiring company's stock (the testing period), then the residency and active business requirement for the stock of the acquiring company would be satisfied.<sup>68</sup> The tax administration illustrated that rule in the context of mergers with four examples.<sup>69</sup> In the first example, A is a company organized in 1996 owning only passive investment real estate property with a net asset value of 1,000x at the time of the merger. B is a company organized in 1998 owning only business assets with a net asset value of 1,500x at the time of the merger. In 2003, A and B merge into newly formed C. Stock of C satisfies the active business requirement if B's net asset value has always exceeded A's net asset value during the testing period (that is, since the first day of 2000 if the stock of the acquiring company is disposed of in 2003).

<sup>66</sup>A more detailed discussion of the tax treatment and operative rules that apply to mergers and acquisitions under Italian tax law is beyond the scope of this article.

<sup>67</sup>Circular 36/E/2004, para. 2.3.6.1.2 and para. 2.3.6.2.

<sup>68</sup>Circular 36/E/2004, para. 2.3.6.4.

<sup>69</sup>Circular 36/E/2004, para. 2.3.6.4.1, examples 13-16.

In the second example, A is company organized in 1996 owning only passive investment real estate property with a net value of 1,000x in 2003 and through the date of the merger and of 2,000x in 2002 and prior years. B is a company organized in 1998 owning only business assets with a net value of 1,500x since its inception and through the date of the merger. In 2004 A and B merge into newly formed C. Stock of C would satisfy the active business requirement only from 2006 and later (assuming net asset value remains unchanged), because only in 2003 and thereafter does the net value of B's business assets exceed the net value of A's disqualified assets.

In the third example, A is a company organized in 1996 owning only passive investment real estate property with a net value of 1,000x since its inception and through the date of the merger. B is a company formed in 2003 and owns business assets with a net value of 1,500x in 2003 and through the time of the merger. In 2003, A and B merge into newly formed C. Stock of C would meet the active business requirement only if a sale occurs in 2006 or thereafter, assuming unchanged asset values, because before 2003, there were no business assets to be confronted with disqualified assets of A.

In the final example, in 2003, a real estate investment company formed in 2003 with a net asset value of 3,000x, and a business company formed in 1986 with a net asset value of 1,000x merge into a newly formed company that, because it owns disqualified assets with a net value equal to more than 50 percent of its total net asset value, does not meet the active business requirement.

None of the examples discuss a merger of a company not engaged in a trade or business and a company engaged in a trade or business. However, in that case, the comparative analysis would apply to determine whether the active business requirement is met. The result of the double-level test and the comparative analysis rules is that stock of a company not meeting the requirements because the company is not engaged in a business or is resident in a blacklisted jurisdiction cannot be purged by simply merging it with or into a company that meets the requirements, unless the net value of the company meeting the requirements has exceeded the net value of the company that did not meet the requirement for three full tax years before the year in which the gain for which the exemption is sought is realized.<sup>70</sup> The comparative analysis approach

<sup>70</sup>Rephrasing it in positive terms, purging can be done by merging a disqualified company with a company that qualifies for the exemption and whose assets have constantly exceeded in value the assets of the disqualified company  
(Footnote continued on next page.)

puts tremendous pressure on appraisal of assets of companies involved in the merger. The tax administration has not clarified whether that valuation should be made on a daily basis or with reference to the average asset value during the tax year.

### C. Spinoffs

Under tax code section 173, if a transaction qualifies as a tax-free spinoff, no gain would be recognized either by the distributing company upon distribution of stock of its subsidiary to its shareholders, or by the distributing company's shareholders upon receipt of stock of the spun-off company on or in exchange for their stock in the distributing company. For participation exemption purposes, for a spinoff that follows a contribution of assets by the distributing company to a newly-formed or preexisting subsidiary whose stock is then distributed up to the distributing company's shareholders (that is, is part of a threshold "D" reorganization in the U.S. tax sense), the residency and active business requirements must be tested by looking both at the subsidiary (spun-off) company and at the distributing company under the same rules that apply for mergers.<sup>71</sup> Therefore, if company A, more than 50 percent of whose assets (by value) are nonbusiness, real estate investment assets (and therefore fails the business requirement test under the special rule for real estate investment company), transfers its real estate investment assets to newly formed subsidiary B and its business assets to newly formed subsidiary C, then distributes the stock of B and C to its shareholders in a good nontaxable spinoff transaction; stock of C does not qualify for the exemption at the time of the spinoff. If more than 50 percent of A's assets were business assets for three full tax years before the year of the spinoff (the testing period), then C stock would qualify for the exemption at the time of the spinoff.<sup>72</sup> If C receives the nonbusiness assets, but is a preexisting subsidiary that has owned business

during the entire testing period. With this comment we would just like to emphasize the final effect and potential tax planning implications of the approach taken by the tax administration. The extent to which such a technique can be used to benefit from the exemption must be evaluated on the basis of the facts of each particular case.

<sup>71</sup>Circular 36/E/2004 does not discuss how the minimum holding period and balance sheet requirements are tested in the context of a spinoff. However, it would seem correct on the basis of the same rules that apply for tax-free contributions and mergers that the distributing company's shareholders take a minimum holding period and balance sheet classification in the subsidiary's stock determined with reference to the holding period and balance sheet classification of their stock in the distributing company.

<sup>72</sup>Those rules are illustrated in examples 17 and 18 in Circular 36/E/2004, para. 2.3.6.4.2.

assets whose value has always exceeded the value of the nonbusiness assets received in the transaction for the entire testing period, then C stock would qualify for the exemption at the time of the spinoff. If B receives the business assets but is a preexisting subsidiary that has owned nonbusiness assets whose value has always exceeded the value of the business assets received in the transaction for the entire testing period, then B stock would not qualify for the exemption.<sup>73</sup>

The ordinary participation exemption rules would apply to determine whether any gain recognized on a transfer of stock in a taxable merger or spinoff would be tax-exempt.<sup>74</sup>

### D. Stock Swaps

Under tax code section 177, if a company acquires stock of another company solely in exchange for its own stock and controls the acquired company after the transaction, the acquired company's shareholders are not taxed on any gain realized on receipt of the acquiring company's stock in exchange for their stock in the acquired company.<sup>75</sup> The acquired company's shareholders take a substituted basis in the

<sup>73</sup>Those rules are illustrated in example 19 of Circular 36/E/2004, para. 2.3.6.4.2. Therefore, when planning a spinoff as part of a threshold "D" reorganization, a taxpayer must be careful in placing the business and nonbusiness assets of the distributing company in the appropriate corporate boxes to maximize the effects of the rules and make sure that the stock distributed in the spinoff immediately qualifies for the exemption after the spinoff, so that any gain recognized in an unrelated disposition of that stock would be exempt from tax.

<sup>74</sup>Tax code section 172(3) provides that if target shareholders receive cash or other property in the merger, they recognize any gain realized in the transaction up to the amount of the cash or other property received under the rules of tax code section 47(7). Therefore, the amount of cash or the fair market value of other property received is treated as a tax-free return of capital or a recovery of shareholder's basis. Any excess is treated as a capital gain, which may be exempt if the stock surrendered in the merger satisfies the requirements for the participation exemption.

<sup>75</sup>That may be considered the analogue of a "B" reorganization in the U.S. tax sense, but with some fundamentally different aspects: (1) the acquiring company can use any of its stock and not just voting stock in the transaction; (2) the control test differs from the IRC 368(c) control required for corporate reorganization purposes ("control" exists if the acquiring company owns more than 50 percent of the voting stock of the acquired company or a sufficient amount of voting stock to exercise dominant influence over the acquired company, or any amount of stock if it can exercise a significant influence over the acquired company other than contractual relationships or arrangements); and (3) consideration issued by the acquiring company can also be cash or other property. Target shareholders that receive cash or other property recognize gain to the extent of the amount of cash or fair market value of that other property. But the gain may be

(Footnote continued on next page.)

acquiring company's stock they receive. The acquiring company takes a carryover basis in the acquired stock of the target. The acquiring company can use cash or other property in the transaction. The acquired company's shareholders who receive cash or other property recognize any gain realized in the exchange to the extent of the amount of cash or the fair market value of other property received, but the gain may be exempt if the stock exchanged qualifies for the participation exemption.<sup>76</sup> Circular 36/E/2004 does not contain any clarifications on the application of the participation exemption in the context of a nontaxable stock-for-stock exchange. By analogy with rules for contributions, mergers, and spinoffs, it can be reasonably concluded that the acquiring company takes a carryover holding period and balance sheet classification in the stock of the target. If stock that does not qualify for the exemption is exchanged for stock that does qualify for the exemption but for the residence of the transferor, any gain realized from the exchange is fully taxable.<sup>77</sup>

### E. Amount of the Exemption

If all requirements are met, the full amount of gain is exempt from tax for corporations under the original rules, and 60 percent of the amount of the gain is exempt for individuals or partnerships. However, effective for gains realized by corporations after October 4, 2005, Legislative Decree 203/2005 has reduced the exempted amount to 95 percent of the gain. Therefore, for corporations, the exempt amount of the gain is equal to the excluded amount of dividends (95 percent).

## V. Constraints on Deductions of Costs and Other Special Rules

### A. Disallowance of Losses

Losses from disposition of stock that qualifies for the exemption are nondeductible.<sup>78</sup> That rule is intended to provide symmetrical treatment for gains and losses from stock falling within the scope of the rules. The symmetrical treatment has been partially abandoned after the increase of the minimum holding period to 18 months. Indeed, the holding period for disallowing losses has remained unchanged.

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exempt if the stock exchanged qualifies for the participation exemption (tax code section 177(4)).

<sup>76</sup>See footnote 72. A more detailed discussion of the stock-for-stock exchange of section 177 is beyond the scope of this article.

<sup>77</sup>Tax code section 177(3) refers to section 175(2). See footnote 60.

<sup>78</sup>Tax code sections 101 and 64.

Therefore, gains from stock held for more than 12 months but less than 18 months before the month of the sale are taxable, while losses are nondeductible.

### B. Limitations on Expense Deduction

Expenses incurred in purchasing and carrying stock that qualifies for the exemption are deductible.<sup>79</sup> Costs incurred in the sale or disposition of tax-exempt stock are nondeductible.<sup>80</sup>

### C. Limitations on Interest Deduction (Financial Pro Rata)

Interest is nondeductible to the extent it is allocable to stock that would qualify for the exemption. That rule is intended to deny the double dip that could be obtained by borrowing money, thereby incurring deductible interest expenses, and using the loan proceeds to purchase stock whose sale would generate tax-exempt gain. To determine the nondeductible portion of interest, tax code section 97 uses a formula in which the amount of interest expense reduced by any nondeductible interest disallowed under the thin capitalization rules net of interest income (that is, net interest expense) is multiplied by a fraction. The numerator is the excess of the book value of tax-exempt stock over the book value of the company's net equity at the end of the tax year. The denominator is the sum of the company's gross assets minus its net equity and trade and accounts payable (all measured by book value terms). The resulting amount of nondeductible interest is reduced by an amount equal to the amount of taxable dividends paid on the stock. The rationale of the formula is to disallow the deduction of net interest expenses to the extent the stock owned by the borrower that qualifies for the exemption is financed with debt (as opposed to the borrower's net equity). Stock of companies that are taxed on a consolidated basis or elected to be treated as fiscally transparent entities are excluded from the computation.

Also in that case, like for the disallowance of losses, the symmetric treatment that was supposed to apply to nondeductible interest/stock generating nontaxable gains has been partially limited. Indeed, for purposes of the financial pro rata, the holding

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<sup>79</sup>The general rule of tax code section 109(5) is that expenses related to assets or activities that generate taxable income or income that is excluded from the tax base are deductible for tax purposes. Because exempt stock may generate taxable and tax-excluded dividends, the rule has been interpreted as allowing the deduction of costs related to the purchase and carrying of tax-exempt stock. (See Circular 26/E/2004, para. 3.6.)

<sup>80</sup>Because the gain would be exempt from tax (but not excluded from the tax base). Typically, nondeductible costs include legal, accounting, appraisal, and notary fees.

period is unchanged. Therefore, the numerator of the fraction includes stock held for more than 12 months but less than 18 months, from which gains would be taxable, but interest is nondeductible.

#### D. Participation Exemption and Tax Consolidation

Under tax code section 123, upon joint election of the transferor and the transferee, property can be transferred between members of the same tax consolidated group without recognition of gain. The transferee takes a carryover basis in the transferred property and recognition of gain is deferred until a transfer of the property outside the group in a taxable transaction. That provision does not apply to a transfer of stock that qualifies for the participation exemption. Then, the gain recognized is exempt under tax code section 87 and the transferee takes a cost basis in the transferred stock. For section 123 nontaxable transfer of stock, the transferee steps into the shoes of the transferor for the balance sheet classification and the holding period of the stock.<sup>81</sup> The holding period of the stock in the hands of the transferor is also considered for the purposes of determining whether the residency requirement for the duration of the testing period is satisfied. As already pointed out in Part V.C above, stock of companies that are members of a tax group do not enter into the formula for the computation of the nondeductible portion of interest expense allocated to exempt stock.

**Contrary to the exemption of gains, no requirements need be satisfied for the dividend exemption to apply.**

Tax code section 122, which provides that the parent company can reduce the taxable income of the group for an amount equal to the taxable amount (5 percent) of dividends paid within the group, has not been amended to include a reduction in the taxable portion of the gain, which is 5 percent under Law Decree 203/2005.

#### E. Participation Exemption and Fiscal Transparency

Under the check-the-box rules of tax code section 176, an Italian limited liability company (S.r.L.)

<sup>81</sup>The rule is the same as the rule that applies for the transfer of exempt stock in a nonrecognition transaction. The carryover treatment is not elective. As a result, the transferee cannot recognize a loss by carrying the stock on its balance sheet as a current asset and selling it outside of the tax group in a taxable transaction. The new balance sheet classification would be disregarded and the loss would be disallowed.

with revenue for a tax year not exceeding €5,164,468.99 (that is, 10 billion Italian lire) and no more than 10 individual shareholders who are either resident individuals or nonresident individuals who own the stock in the entity through a PE in Italy (and therefore would not be subject to withholding tax on the dividends payable by the entity) can elect to be treated as a fiscally transparent entity.<sup>82</sup> However, the election cannot be made if the entity owns stock that qualifies for the participation exemption. The reason for the rule is to prevent shareholders from converting a gain that would be partially taxable (40 percent of the amount) if holding the stock directly into a totally tax-exempt gain by holding the stock to a fiscally transparent S.r.L.<sup>83</sup> A new rule in the technical corrections bill would permit the election, but would provide that the gain must be separately stated and taxed in accordance with the tax profile of the shareholders.

#### F. Exemption of Dividends

Ninety-five percent of dividends received by resident companies<sup>84</sup> or PEs in Italy of nonresident entities of any type<sup>85</sup> are exempt from tax. The exempt portion of a dividend received by a partnership<sup>86</sup> or sole proprietorship is 60 percent. With the reduction of the exempt amount of gain from 100 percent to 95 percent for corporations, dividends and gains are taxed (or exempt) alike. However, contrary to the exemption of gains, no requirements need be satisfied for the dividend exemption to apply. The only limitation is that dividends paid by entities that are resident in a blacklisted jurisdiction are fully taxable.<sup>87</sup>

#### G. Transitory Rules

Gains from disposition of exempt stock that are recognized within the end of the second tax year

<sup>82</sup>For a review of Italy's check-the-box rules, see Marco Rossi, "Italy's Check-the-Box Rules," *Tax Notes Int'l*, July 25, 2005, p. 329.

<sup>83</sup>The tax treatment of the gain is determined at the entity's level as if the entity were a company.

<sup>84</sup>We use that term to designate all entities treated as separate taxable entities and subject to corporate income tax (*i.e.*, corporations in the U.S. tax sense).

<sup>85</sup>Regardless of their legal form and tax treatment under the foreign country.

<sup>86</sup>We use that term to designate all entities treated as fiscally transparent; they are not subject to tax, but their incomes pass through to the partners who are taxed on their distributive share of the entity's income.

<sup>87</sup>As a result of the partial exemption, dividends of corporate shareholders are taxed at an effective tax rate of 1.65 percent, while dividends of individual shareholders holding stock through a partnership, or directly but within the conduct of a trade or business, are taxed at a maximum effective tax rate of 18 percent.

beginning on or after December 31, 2003, are taxable to the extent of the amount of previous unrealized losses that had been recognized on the transferred stock during the two tax years ending on or before December 31, 2003. For calendar-year taxpayers, that means that gains recognized within December 31, 2005, that are otherwise exempt under the participation exemption rules are taxable to the extent of the amount of any unrealized losses that had been recognized for tax purposes not earlier than January 1, 2002. Law Decree 203/2005 has extended the recapture period to four tax years beginning on or after December 31, 2003 (that is, through December 31, 2007, for calendar-year taxpayers).

## VI. Conclusion

Italy's participation exemption rules are elaborate and sometimes complex. They provide a favorable exemption of gains from the disposition of stock. The exemption applies to any stock held in both corporate and fiscally transparent entities, as well as other instruments, contractual joint venture arrangements treated as equity for tax purposes, and shares of stock of foreign entities of any type. Notably, the exemption applies without regard to the amount of stock owned in the participated entity. Specific requirements must be met to benefit from the exemption, but special rules on the application of those requirements for stock owned through holding companies make it easier to satisfy the rules with

appropriate tax planning. In other situations, transfer of stock in nontaxable transactions (contributions, mergers and spinoffs, stock swaps) may also be used to purge ineligible stock and allow it to be disposed of without recognition of gain. Companion rules on exemption of dividends increase the beneficial treatment of corporate earnings because the exemption in that case, although only partial, is substantial for corporate shareholders and is granted without regard to the requirements established for the exemption of gain. The only condition is that the distributing company must not be resident in a blacklisted jurisdiction (then, the dividend is fully taxed). The new participation exemption rules put Italy more in the mainstream with regard to its corporate income tax system. Whether they are sufficient to help Italy compete with the other more traditional holding company jurisdictions in the European Union remains doubtful. In the end, they should facilitate investment in Italy by offering good planning opportunities to help the movement or disposition of stock to unwind possible unwanted sandwich structures and implement more tax effective exit strategies. Unfortunately, the restrictive amendment of the rules after less than two years reveals the Italian government's perennial inability to properly pursue long-term plans under the pressure of contingent political and budget concerns and offer sufficiently stable and reliable rules, which are vital to attract and keep foreign investments. ♦