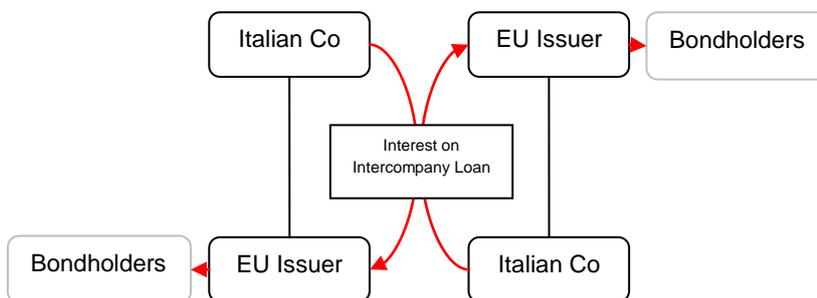


New withholding tax on indirect bond issuances

The Italian government has just introduced new legislation which is intended to regulate the tax regime of indirect bond issuances, including those made by a foreign affiliate of an Italian non-listed company and guaranteed by that Italian company. The new legislation takes the form of a decree-law, that must be converted by the Parliament into law, with eventual amendments, within 60 days (if not converted, the decree would cease to produce any further effect).

The typical scenario to which the new legislation would apply is that of an Italian company paying a interest on an intercompany loan to a foreign affiliate (established within the European Union) which has issued bonds on the international capital markets, which bonds are guaranteed by the Italian company or another group company (as better specified below).

The following diagram depicts the affected structures:



Absent this new legislation, there might be uncertainty as to whether interest payable by the Italian borrower in respect of the intercompany or proceeds loan depicted in the above structures to the foreign issuer can be deemed to be beneficially owned by the issuer (and not by the bondholders), thus benefiting from the exemption from withholding tax applicable to intercompany loans under the Interest and Royalties Directive. The new piece of legislation helps doing away with this uncertainty and provides that, when the beneficial ownership test is not met, the interest is subject to a straight 5% withholding tax, provided that:

- the interest is payable to "finance" the payment of interest by the foreign affiliate on bonds issued by it and listed on a regulated market of a EU member state of or a EEA member state allowing an adequate exchange of information; and
- the bonds are guaranteed by the Italian company or by the ultimate parent company of the group or by another company controlled by the same parent company as the company paying the interest to the issuer.

Key Issues

Indirect bond issuances with ultimate Italian borrower

5% withholding tax

0.25% registration tax

If you would like to know more about the subjects covered in this publication or our services, please contact:

[Carlo Galli](#)

[Giuseppe De Palma](#)

To email one of the above, please use firstname.lastname@cliffordchance.com

Clifford Chance Studio Legale,
Piazzetta M.Bossi, 3 - 20121 Milan
T. +39 02 806341

Via di Villa Sacchetti, 11 – 00197 Rome
T. +39 06 422911
www.cliffordchance.com

In such a case,

- (i) the interest payable by the Italian borrower to the foreign issuer would be subject to a 5% withholding tax; and
- (ii) any guarantee given by the Italian company will "in any case" be subject to a 0.25% registration tax; the meaning of the words "in any case" ought to be clarified as it is not clear whether it means that the tax is meant to apply regardless of where, or the form in which, the guarantee is executed or whether or not in the relevant structure there was an actual payment of Italian source interest.

The new legislation acknowledges that Italian companies may be financed through loans extended by foreign affiliates who themselves gather funding by issuing bonds on the international capital markets. In such structures, the issue has normally been that of securing the tax regime of the interest payable by the Italian borrower to the foreign issuer, i.e. the full exemption provided under the Interest and Royalties Directive. When such structures are purely "back-to-back" arrangements, where the interest on the bonds is directly and/or substantially serviced through the interest-stream payable by the Italian company on the proceeds loan (see diagram above), the beneficial ownership by the foreign issuer of such Italian source interest may be difficult to assert, thus putting at risk the exemption on the inter-company interest under the Interest and Royalties Directive. In such cases, a successful challenge by the tax authorities on the question of beneficial ownership exposes the Italian company (and the structure as a whole), to the risk of application of a 12.5% withholding tax (and potentially significant penalties for tax avoidance) on the interest on the proceeds loan *on the grounds that the bondholders are deemed to be receiving the Italian source interest directly from the Italian company*. Accordingly, the new provision (if converted into Law) would significantly simplify the analysis applicable to structures where there may be doubt over the applicability of the beneficial ownership test by providing for a 5% withholding tax whenever the beneficial ownership test cannot be met.

On the other hand, the new withholding tax regime should not apply to those structures where the beneficial ownership test is satisfied (for example, where the foreign issuer is a fully operative group holding and/or finance company that is raising funds for the group as a whole). In such cases, the withholding tax exemption for intra-EU interest payments should continue to apply.

The new withholding tax regime should apply on interest paid as of 6th July 2011, regardless on when the structure was set up (thus impacting also on existing structures). It will also apply to interest paid prior to that date but in such case the withholding tax would be levied at 6% but no registration tax will be payable on any deed of guarantee.

Carlo Galli, Head of the Tax Group, comments: "*The new legislation would remove the significant uncertainty currently in the market and should allow unlisted Italian companies easier access to funding on the international capital markets. By having foreign parent or subsidiary companies issuing on the market and then on-lending the proceeds to an Italian company, the withholding tax cost of the structure will be certain and limited to 5%. Italian companies funded through such structures would no longer be exposed to the risk that the beneficial ownership test is not passed and be subjected to the risk of a 12.5% withholding tax and the risk of penalties.*"

Giuseppe De Palma, Head of the Banking and Finance Group adds: "*If confirmed, this would be a timely piece of legislation. In common with other jurisdictions, the loan financing of many Italian groups is coming up for refinancing and given the current buoyancy of the international debt capital markets, it is of vital importance for the Italian economy that also un-listed Italian companies are able to tap into those markets with certainty as to the applicable fiscal regime.*"

This Client briefing does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

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