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C H A N C E

Client briefing
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Major overhaul of the tax regime of interest, dividends and capital gains: single 20% rate enacted

The Italian Government just issued a decree law containing a set of extraordinary measures to stabilize public finances and respond to the heavy pressure in such direction by EU partners and the European Central Bank. The Decree Law 138/2011 introduces significant changes to the tax regime of income from financial sources (such as interest, dividends and capital gains on shares and other securities) which affect mainly individual investors and non-resident investors not acting through an Italian permanent establishment. The new changes only marginally affect the tax regime of income and gains realized by Italian businesses or Italian permanent establishments of foreign businesses.

The Decree Law 138/2011 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 most significant tax measures can be summarized as follows.

Uniform 20% rate on financial income

Save for the exceptions described below, all withholding and substitute taxes on Italian income and gains derived from financial income, formerly set at either 12.5% or 27%, shall be set at a uniform rate of 20%. The change will affect all financial income (known as "income from capital") and capital gains (known as "miscellaneous income"), such as interest, dividends, income and gains from the investment in Italian and EU qualifying collective investment undertakings, income and gains from the investment in life insurance policies, repos and securities lending.

The table in the annex to this Briefing outlines the changes to the specific items of income and gains. Exemptions that are currently available under the existing legislation are unaffected by the new changes.

The most notable **exceptions** either contemplated by the new decree law or by the existing legislation not amended by it are as follows:

- Income and gains from Italian **State bonds** ad comparable securities issued by one of the States deemed to allow an adequate exchange of information: continue to be subject to tax at **12.5%**;
- Bonds issued by the special bank for the **development of Southern Italy** to fund such development: continue to be subject to tax at **12.5%**;
- Income and gains included in the taxable appreciation of qualifying **pension funds:** continue to be subject to tax at **11%**;
- Interest on loans paid to **EU affiliates** and used by the same to fund the payment of interest on certain qualifying issuances of bonds, where the foreign affiliate/issuer cannot be regarded as the beneficial owner of the interest: continue to be subject to the (recently introduced) **5%** withholding tax; and

Key issues

Uniform 20% rate on financial income

Taxation of regulatory capital of banks and insurance companies

Strict limitations on the deduction of interest on bonds issued by unlisted companies confirmed

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- **Dividends** paid to qualifying companies resident of a EU or EEA member State allowing an adequate exchange of information, and which are the beneficial owners of such dividends: continue to be subject to withholding tax at **1.375**%.

The new uniform tax regime at 20% will eliminate several, but not all, the differences in treatment on interest on securities. In particular, interest on bonds shall in principle be subject to tax at source at 20%, regardless of the original maturity of the bond or the type of issuer. The 20% surcharge applicable under the amended legislation in the case of early redemption of bonds issued with original maturity in excess of 18 months and redeemed prior to the 18th month will no longer apply.

A fundamental distinction will survive despite the new legislation between (i) securities subject to tax under Legislative Decree 239 of 1 April 1996 ("**Decree 239**"), i.e. bonds having an original maturity over 18 months and issued by banks, listed companies, securitisation vehicles and securities issued by banks and insurance companies to comply with the capital adequacy requirements (see below), and (ii) other securities, including so-called "atypical securities".

Accordingly, income from securities subject to the Decree 239 will be subject to substitute tax (at the new rate of 20%) applicable by the intermediary holding the securities on deposit and will be eligible for exemption when earned by white listed participants. Conversely, income from "atypical securities" will continue to be subject to withholding tax (at the new rate of 20%) applicable by the issuer and will not be eligible for the white-list-based exemption.

The **effective date** of the new 20% general rate shall be as follows:

- In the case of interest and other financial income other than interest on bonds issued by listed companies, banks or securitisation vehicles or interest on bonds issued by non-residents (i.e. all interest subject to the regime of Legislative Decree 239 of 1 April 1996), on income payable as of (or following) 1 January 2012;

- In the case of interest on bonds issued by listed companies, banks or securitisation vehicles or interest on bonds issued by non-residents, on income accrued as of (or following) 1 January 2012;

- In the case of dividends, to the extent received as of (or following) 1 January 2012;

- In the case of capital gains, to the extent realized as of (or following) 1 January 2012.

Taxation of regulatory capital of banks and insurance companies

The Decree also clarifies that securities other than shares issued by companies subject to the regulatory control of the Bank of Italy or the Insurance Regulator – i.e. banks and insurance companies – to comply with capital adequacy requirements, shall be subject to the tax regime provided under Legislative Decree 239 of 1 April 1996. The new provision eliminates the current uncertainty as to whether such securities are to be regarded (and treated) as "atypical securities". Accordingly as a result of the Decree:

- Interest on such securities shall be subject to a (now) 20% substitute tax applied by the intermediary instead of being exposed to the risk of being subject to a 27% withholding tax applicable by the issuer;

- Securities holders resident in white-listed states shall be eligible for full exemption from Italian tax.

The new regime shall apply to interest on securities issued as of 20 July 2011. Without prejudice to any applicable exemptions, interest accrued as of 1 January 2012 shall be subject to tax at 20% instead of 12.5%, in line with the new general tax regime on financial income and gains.

Strict limitations on the deduction of interest on bonds issued by unlisted companies confirmed

Contrary to the expectation of market operators, the Decree confirms the current provision whereby the deduction on interest on bonds issued by unlisted Italian companies is disallowed above a certain threshold. Under the Decree, interest on such bonds will not be deductible if exceeding:

- 200% of the ECB reference rate, in the case of bonds listed on a regulated market of a EU or EEA member State or offered to the public;

- 166% of the ECB reference rate in the case of bonds other than the above.

Hence, interest on bonds directly issued by unlisted Italian companies will be still deductible up to the above reference rates multiple but interest in excess of the above rate will not be deductible.

Carlo Galli, head of the Italian Tax Department comments the New Decree as follows: "*The new rate may change significantly the economics of cross border financial transactions. As of 1 January 2012 the access to either treaty or domestic law-based exemptions and reliefs will become much more relevant and the structuring of transactions will require more expert input to avoid incurring additional tax leakages* ".

The following table outlines the changes from the current to the new regime

Interest		**Until 31/12/2011**	**As of 1/1/2012**	**Notes**
	Loans	12.5% WHT	20% WHT	Not on proceeds loans on indirect issuances (subject to 5% WHT)
	Long term bonds	12.5% ST	20% ST	Not on State bonds and similar securities. Cross-border exemptions unaffected
	Short term bonds and commercial papers	27% WHT	20% WHT	Not on State bonds and similar securities
	Deposits and current accounts	27% WHT	20% WHT	Cross-border exemptions unaffected
	Atypical securities	27% WHT	20% WHT	
Dividends				
	Ordinary shares	27% WHT	20% WHT	1.375% WHT on intra EU/EEA dividends unaffected
	Saving shares	12.5% WHT	20% WHT	
Other				
	Income from units of Italian and EU/EEA collective investment vehicles	12.5% WHT	20% WHT	Cross-border exemptions unaffected
	Income from insurance policies	12.5% WHT	20% WHT	
	Income from repos and securities lending	12.5% WHT	20% WHT	Cross-border exemptions unaffected
Capital gains				
	Shares	12.5% ST	20% ST	Cross-border exemptions unaffected. Tax regime of substantial participations unchanged
	Bonds	12.5% ST	20% ST	Cross-border exemptions unaffected
	Gains from units of collective investment vehicles	12.5% ST	20% ST	Cross-border exemptions unaffected
	Derivatives	12.5% ST	20% ST	Cross-border exemptions unaffected

WHT: withholding tax, applied by the issuer

ST: substitute tax, applied by a financial intermediary intervening in the transaction

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