- A rate of 15 per cent applies to other specific cases of dividends and royalties.[41]

Going back to the double tax treaties concluded by Belgium – once briefly exposed the main features of the Belgian domestic taxation[42] on capital gains – it should be noted, on balance, that this provision related to gains from the alienation of shares forming part of a substantial holding in a company which is a resident of a Contracting State, has also been incorporated to other recent tax conventions such as those signed with Mexico, Norway, India and Vietnam, respectively.[43]

This international treaty practice reflects, in our opinion, the convenience of an explicit reference to that aspect concerning the taxation of capital gains in the text of the OECD Model Convention (in contrast to the short sentence provided now in the Commentary), as it has already been claimed by some member countries through reservations made on Art. 13 of the OECD Model Convention.[44] The improvement of this provision by adding the indicated clause would not only approach the wording of this Article to the UN and the US Model Conventions – whose texts expressly reflect this issue – but it would also mean a better adequation of its content to the current tax treaty practice.

Notes

[41] See Kesti, n. 36 above, pp. 75 and 76.

[42] In this sense, it is significant to take in mind that the Belgian Government has recently announced reforms of labour and capital income taxation. See David Carey, 'Tax reform in Belgium', Economics Department Working Papers no. 354, ECO/WKP (2003) 8, 15 May 2003 (available through OECD's Internet Web site at *http://www.oecd.org/eco*). This paper was originally produced for the OECD Economic Survey of Belgium, which was published in February 2003 under the authority of the Economic Development Review Committee.

[43] Whereas the India-Belgium Income Tax Treaty only exiges a participation of at least 10 per cent of the capital stock of a company (similarly to the India-Spain Double Tax Treaty commented above), the double taxation conventions concluded with Mexico and Vietnam, respectively, refer to a participation percentage of 25 per cent. The Norway-Belgium Tax Treaty exiges, finally, a substantial participation of at least 30 per cent in this respect.

[44] As previously mentioned, France, Japan, Korea and Spain have reserved the right to tax gains from the alienation of shares or other rights which are part of a substantial participation in a company which is a resident in each respective state. See paras. 36, 42 and 45 of the OECD Model Convention Commentary on Art. 13.

Italian Thin Capitalization Rules, Tax Treaties and EC Law: Much Ado About Something

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1. Introduction

The first building within the framework of the major tax reform project,[1] the new Corporate Income Tax[2] imports into the Italian system many previously unknown provisions, such as participation exemption, consolidated base taxation and thin capitalization: this last set of rules is the subject matter of the present Art..

First of all, current provisions – already in force for tax periods commencing on or after 1 January 2004 – are discussed in section 1; their relationship with the Italian tax treaty network is then dealt with in section 2, along with their potential application to permanent establishments. Section 3 addresses the issue of compatibility with EC primary law (a topic that does not end with *Lankhorst*[3]) and the influence on the application of the Parent-Subsidiary and the Interest and Royalties Directives; last but not least, section 4 gives an outline of 'big picture' regarding restrictions on interest expenses.

Notes

* This article is dedicated to the memory of Mariuccia Zavattoni (1923–2004). The authors would like to thank Fabio Aramini, Stefano Grilli, Wolfgang Oepen, Dr. Pasquale Pistone and Raffaele Russo, for their precious comments and suggestions and Safina Khan, UK Barrister (the Middle Temple) for reviewing the language.

[1] Following a proposal dating back as far as 2001, Parliament eventually delegated Government to enact the tax reform with the Act of 7 April 2003, no. 80, published in the *Official Gazette*, no. 91 of 18 April 2003.

[2] The legislative decree, 12 December 2003, no. 344, published in supplement 190 to the *Official Gazette*, no. 291 of 16 December 2003, amends so heavily the existing Income Tax Code, that many practitioners now call it 'the NEW code'.

[3] Case C-324/00 *Lankhorst-Hohorst GmbH v Finanzamt Steinfurt*, ECJ, 12 December 2002.

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2. A road map to Italian thin capitalization rules

Thin capitalization rules are seldom straightforward and the Italian one is no exception. Art. 98 of the Income Tax Code provides that interest expenses on loans granted (or guaranteed) by a qualified shareholder (or a related party thereof) are not deductible, to the extent such loans exceed four times[4] the adjusted net equity attributable to the concerned qualified shareholder.

In practice, a detailed analysis of the rule requires going through the following tests, each of which will be the subject matter of one of the subsequent paragraphs:

1. the exceptions to the rule;
2. the personal scope, i.e. the status of qualified shareholder (and related party thereof);
3. the substantive scope with respect to debt, i.e. the nature of a loan and its being granted or guaranteed by one of the above subjects;
4. the substantive scope with respect to equity, i.e. the nature of net equity and its being attributable to one of the above subjects;
5. the 'overall' check, in which debt and equity are compared, pertaining to *all* qualified shareholders together;
6. the 'per-head' check, in which debt and equity are compared, for each qualified shareholder;
7. the determination of the non deductible part of interest expenses;
8. the safe harbour provision for autonomous credit standing.

Last but not least, we should not overlook an extremely important consequence of Art. 98 (albeit one contained in different provisions): to the extent interest expenses are non-deductible in the hands of the paying company, they will be treated as dividends in the hands of the qualified shareholder granting the loan;[5] a detailed analysis of the consequences of this principle under domestic law[6] will be the subject matter of the last paragraph of this first section.

A. Targets and exceptions

In principle, all corporate income tax subjects[7] are within the scope of thin capitalization rules; this means that foreign corporations and partnerships – to the extent a permanent establishment[8] in Italy arises[9] – are also subject to it. However, an important exception is provided for by Art. 98(7) of the Income Tax Code, under which taxpayers whose turnover does not exceed €5.164.569[10] are out of the scope of thin capitalization rules. An exception to the exception, holding companies – defined as those 'carrying out on an exclusive or prevalent basis the activity of holding participations' (*assunzione di partecipazioni*) – are nevertheless always subject to thin capitalization rules, i.e. irrespective of their turnover.

The exemption for banks and financial companies[11] is somewhat less clearly stated: what Art. 98(5) provides is not that they are *subjectively* out of the scope of thin capitalization rules: it just states that loans taken on in the course of a banking or financial business are *objectively* not to be taken into account for the purpose of determining the 'per-head' check.[12] Nevertheless, the provision does eventually result in an exemption for banks and financial companies; again, holding companies – even to the extent they were performing financial activities[13] – do not benefit from the exemption.

Notes

4 Article 4(1)(b) of legislative decree 344/03 provides that – for the first tax period starting on or after 1 January 2004 – the debt/equity ratio is increased to five to one.

5 However, when a qualified shareholder guarantees a loan, this dividend treatment is available neither to such shareholder, nor to the guaranteed bank, so that eventually economic double taxation arises.

6 Reference is made to paragraphs 3.B. for tax treaty issues and 4.A., 4.C. and 4.D. for EC law issues.

7 Article 73 of the Income Tax Code provides that the corporate income tax applies to (a) corporations, (b) public and private commercial bodies, (c) public and private non-commercial bodies and (d) foreign companies of any kind (i.e. including partnerships).

8 Article 152 of the Income Tax Code; if no permanent establishment arises, the foreign entity is still subject to corporate income tax, but taxable income is to be determined as the aggregate of real estate income, income from capital and miscellaneous income.

9 Article 162 of the Income Tax Code provides for the domestic definition of permanent establishment; for comments see Raffaele Russo, 'International Aspects of the Proposed Corporate Tax Reform – A Comment', *European Taxation* 2003, vol. 43, no. 9, pp. 304–319, at 316.

10 This threshold – formerly a more understandable ITL10 billion – is defined as the one under which the '*studi di settore*' apply: they are a series of procedures for establishing a benchmark minimum level of taxes for small businesses and self-employed individuals, based on some data provided by the taxpayer and on statistics.

11 A financial company for thin cap purposes is identified by reference to the scope of legislative decree 27 January 1992, no. 87, implementing in Italy Directive no. 86/635/EEC of the Council of 8 December 1986 (concerning yearly and consolidated financial statements of banks and other financial companies) and Directive no. 89/117/EEC of the Council of 13 February 1989 (concerning disclosure duties of accounting documents of branches, established in a Member State, of banks and financial companies having their seat outside of such Member State). Being out of the scope of legislative decree 87/92, insurance companies are fully subject to thin capitalization rules.

12 A systematic interpretation would also allow them not to be taken into account for the purpose of computing the 'overall' check.

13 In its instructions for the accounting of financial entities, the Italian Central Bank holds that '*assunzione di partecipazioni*' is to be considered as a 'financial' activity only to the extent it's carried out for the purpose of subsequently selling the shares. In other words, the holding of participations is deemed as a 'financial' business only to the extent it turns into merchant banking, i.e. a 'financial investment activity whose purpose is managing the participations held and increasing their value, with the perspective of selling them when such a sale would be more advantageous, also taking into account the opportunity of reinvesting in other participations' (see the Assonime Circular, 3 January 1994, no. 1, pp. 2–3). In this respect, it should be noticed that Art. 1(3) of the above-mentioned legislative decree 27 January 1992, no. 87 provides that 'for the purposes of this decree, holding participations in order to subsequently sell them is always considered as a financial activity'.

B. Personal scope: the qualified shareholder and its related parties

Under Art. 98(3)(c) of the Income Tax Code, a shareholder is qualified:[14]

(1) when directly or indirectly controlling the debtor company under Art. 2359 of the Civil Code; or
(2) when holding at least a 25 per cent stake in the capital of the debtor company, taking into account also related parties' stakes.

An exception is provided for subjects under Art. 74 of the Income Tax Code, which can never be considered as qualified shareholders. These are the state, local governments and municipalities (and syndicates thereof); from a literal reading of the provision, however, it looks like state-owned companies can be considered as qualified shareholders.

1. Controlling the debtor

Inasmuch it makes reference to Art. 2359 of the Civil Code, Art. 98(3)(c)(1) enjoys a clear and strong set of rules, which has already been relied on several times in tax law, albeit with sometimes different specifications.[15]

Article 2359(1) of the Civil Code provides that the following companies are considered as controlled:

(1) those in which another company holds the majority of voting rights in the ordinary shareholders' meeting;[16]
(2) those in which another company holds enough voting rights to exercise a dominant influence in the ordinary shareholders' meeting;[17]
(3) those under dominant influence of another company due to peculiar contractual relationships with this latter.[18]

For the purpose of applying paras. (1) and (2) of Art. 2359(1), voting rights of controlled companies are also taken into account, as well as those of trust companies and interposed parties; voting rights for the account of third parties are not taken into account.

Whilst paras. (1) and (2) of Art. 2359(1) apply quite simply to the situation under exam, the application of para. 3 is less straightforward.[19] True, some time ago the Ministry of Finance did hold such kind of control not to be relevant for purposes of the (now repealed) substitutive taxation on the sale of control holdings.[20] However, in that context the notion of control was employed in an objective sense, i.e. it was tied to the participation whose sale was to benefit from the peculiar regime, so that it was consistent to hold the external control – which, being based on peculiar contractual relationships, may not be tied to a participation – as irrelevant for those specific purposes. In the thin capitalization context, on the other hand, there is no such objective requirement and as a result we doubt that Art. 2359(1)(3) could be disposed of so easily.

2. 25 per cent stake in the capital

The scope of Art. 98(3)(c)(2) is somewhat less chartered. The 'stake in capital' concept was already present in the text of old Art. 96*bis*, concerning the implementation in Italy of the Parent-Subsidiary Directive; in that context, it had been held[21] that voting rights did not matter. Indeed, the above interpretation could have been influenced by the fact that the Parent-Subsidiary Directive expressly leaves to Member States the choice whether to employ capital or voting rights,[22] so that the choice of either method must be interpreted as a waiver of the other one (since the Directive leaves no space for applying them simultaneously). However, apart from the context of the directive, the choice between capital and voting rights is always structural, even if no EC directive is being implemented.[23] There being no reference to

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14 Please take notice that the two requirements are in an 'either/or' relationship, not in a 'both/and' one, i.e. a qualified shareholder only needs to meet one of them; in this respect, see the ministerial report of the draft legislative decree.

15 For a good examination of the concept of control in Italian tax law, see para. 4 of Antonio Russo and Davide Morabito, 'Parent-Subsidiary Directive: Discussion of a Controversial Position Taken by the Italian Tax Authorities', *European Taxation* 2002, vol. 42, no. 12, pp. 501–506, at 503.

16 This is sometimes referred to as *de iure* control, i.e. control under the law.

17 This is sometimes referred to as *de facto* control, i.e. actual control.

18 This is sometimes referred to as external control.

19 Holding that para. 3 of Art. 2359(1) should not apply is Tancredi Marino, 'Prime riflessioni sull'introduzione della norma di contrasto all'utilizzo fiscale della sottocapitalizzazione', *Bollettino Tributario*, 2004, no. 1, pp. 14–29, at 20.

20 Ministry of Finance Circular 19 December 1997, no. 320/E, para. 1.3.2 stated that 'the provision under exam links the control .. situation exclusively to the participations sold and so no relevance should be given to control . . . arising from other situations.
On these bases, whenever control arises under Art. 2359(1)(3) of the Civil Code, not through an equity holding, but only due to peculiar contractual relationships, said control is not relevant to our purposes.
Therefore, taking into account that only control arising from the availability of the majority of voting rights in the ordinary shareholders' meeting under Art. 2359(1)(1) shall be taken into account, or from the availability of enough voting rights to exercise a dominant influence in the ordinary shareholders' meeting under Art. 2359(1)(2), no relevance should be given to participations granting no voting right (e.g. those represented by privileged or saving shares)'.

21 In this sense, see e.g. the Assonime Circular 63 of 1994, concerning the implementation of the Parent-Subsidiary Directive.

22 Article 3(1)(a) of Directive 90/435/EEC indeed provides for '*a minimum holding of 25 per cent in the capital*', while the following paragraph leaves to Member States 'the option of . . . replacing . . . the criterion of a holding in the capital by that of a holding of voting rights'.

23 One of the best known examples in Italian tax law is provided by Art. 67(1)(c) of the Income Tax Code, which provides for two different sets of thresholds – one in terms of voting rights and the other in terms of capital stakes – for assessing whether a holding is to be considered as qualified for capital gains purposes.

voting rights in the text of the provision, we therefore submit that – to the extent no control situation arises under Art. 2359 of the Civil Code – the 25 per cent threshold is not exceeded if 25 per cent or more of voting rights are secured by holding less that 25 per cent of capital.[24]

> **Case study A**
> Shareholder A holds 45 per cent of ItaCo shares, of which 15 per cent are his own, 15 per cent in usufruct (bare owner being shareholder B) and 15 per cent in pledge from shareholder C. Both usufruct and pledge rights grant the holder thereof the vote, without any entitlement to refund of capital or other capital-related rights. Therefore – absent any control requirement under Art. 98(3)(c)(1) – shareholder A should not be considered as a qualified shareholder for thin capitalization purposes.

On the other hand, the 25 per cent threshold could be exceeded even if no voting right was secured, as the following example shows.

> **Case study B**
> ItaCo's capital of 100 is divided in 60 ordinary shares (with voting rights), 20 privileged shares (no voting rights in the ordinary shareholders' meeting) and 20 saving shares (no voting rights in either the ordinary or the extraordinary shareholders meetings). If shareholder X holds no ordinary share, but he holds 15 privileged shares and 10 saving shares, he should be considered as a qualified shareholder for thin capitalization purposes.

In borderline situations, in order to determine whether a certain (corporate) right amounts to a 'stake in capital' for purposes of Art. 98(3)(c)(2), we submit that the following aspects should be taken into account:

- corporate rights and duties, i.e. claims in liquidation proceeds (if any) and obligations thereof (e.g. payment of outstanding capital contributions);
- pre-emptive rights in the event of a capital increase;
- entitlement to a dividend.

3. Related parties

The purpose of the related party concept is twofold:

- to aggregate the stakes in the capital of the debtor company for purposes of assessing qualified shareholder status under Art. 98(3)(c)(2);
- once a qualified shareholder has been established (whether on its own right or due to its related parties), to determine the subjects whose loans and equity stakes will be cumulated with such shareholder's in the further steps of thin capitalization calculations.

Under Art. 98(3)(b), a related party of a qualified shareholder is:

- any company controlled by such qualified shareholder under Art. 2359 of the Civil Code;
- (provided of course the qualified shareholder is an individual) relatives under Art. 5(5) of the Income Tax Code, i.e. the spouse, in-laws up to the second degree and relations up to the third degree.[25]

It should be noted that – to the extent it is based on Art. 2359 of the Civil Code – the related party concept only works in one way: a controlled company is a related party of the controlling company (top down), but under no circumstance can the latter be considered as a related party of the former. This means that the qualified shareholder will always be the top controlling company in the chain, while its subsidiaries will only enjoy related party status.[26]

> **Case study C**
> Company A holds 100 per cent (both in terms of capital and voting rights) of company B. Company A also holds 20 per cent of company C, whose other 80 per cent is held by company B. Even if company B would be a qualified shareholder of company C in its own right, still we should be considering company A as the only rightful qualified shareholder of company C – both on grounds of control under Art. 2359 of the Civil Code and of stake in the capital together with the related party – while company B only qualified as a related party of company A.

On the other hand, the related party provision based on family ties works both ways, so that not only will a son be a related party of his qualified shareholder father (top down), the latter will reciprocally be a related party of the former (bottom up). Eventually, we will be dealing with 'qualified family groups', in which there will be little purpose (if any) in determining who is leading as qualified shareholder and who is following as a related party.

Notes

[24] Mario Bono and Marco Piazza, 'Per i debiti il 'peso' dei soci', *Il Sole-24 ore* of 8 November 2003, p. 22.

[25] Under Art. 76 of the Civil Code, each generation accounts for a degree, but for the common ancestor; e.g. the uncle of X is a third degree relation (two degrees going up to X's grandfather and one going down to the uncle). The following Art. 78 provides that inasmuch one is a relation of one spouse, he's an in-law of the other; e.g. Y's brother-in-law is a second degree (one degree going up to the mother-in-law and one going down to the brother).

[26] This view is shared by Luca Rossi and Paolo Scarioni, 'Appunti in tema di capitalizzazione sottile', *Bollettino Tributario* 2004, no. 2, pp. 95a–100, at 95; the scope of the delegating act indeed was broader, so that an opposite conclusion – i.e. top controlling company as related party of its subsidiary, the latter being qualified shareholder of the debtor company – could indeed have been reached: see Natale Girolamo, Luca Rossi and Paolo Scarioni, 'La "thin capitalization rule" o regola di "sovraindebitamento" ', *Bollettino Tributario* 2002, no. 22, pp. 1616–1621, at 1617.

Case study D
A, B, C, D and E are five brothers, as well as ItaCo's shareholders, each of them with a 20 per cent stake (both in terms of capital and voting rights); even if none of them would be a qualified shareholder in his own right, they are still related parties to one another, with the result that all loans granted (or guaranteed) by any brother (or related party thereof) are tainted for thin capitalization purposes.

Family attribution rules are dangerous provisions, often leading to unforeseen consequences, some of which are clearly undesirable: the backbone of Italian economy being made by family-owned businesses (a lot of which are now second or third-generation), there is no need of a fortune-teller to predict substantial regulatory development in this area.

Case study E
Same facts as in case study D: the five brothers die and their 20 per cent stakes in ItaCo are inherited by their five children (A Jr., B Jr., C Jr., D Jr. and E Jr.), so that ItaCo's shareholders are now the five cousins. Since each cousin is a fourth degree relative of another, none of them is a related party to one another and ItaCo no longer is affected by thin capitalization issues. This situation would change if their grandmother F was still alive, as then each cousin would be a – second degree relative – related party to her and as a result, again, all loans granted (or guaranteed) by any cousin (or related party thereof) would be tainted for thin capitalization purposes.

4. Timing issues

When is qualified shareholder status relevant for thin capitalization purposes? At an earlier stage, it was argued that reference should be made to the time that the loan is granted (or guaranteed): if it is granted/guaranteed by a qualified shareholder (or related party thereof), then the loan is relevant for thin capitalization purposes; if it's not granted/guaranteed by a qualified shareholder (or related party thereof), then no thin capitalization issue arises.[27] A similar result could also be achieved by way of applying the safe harbour proviso of Art. 98(2)(b).[28] However, the above principle has since been considerably cooled down and indeed – from the context of the thin capitalization provision at large – it looks like a mere historical reference to the time a loan is granted (or guaranteed) is not entirely consistent with either the purpose or the technicalities of thin capitalization.

We submit that no autonomous timing requirement should be sought for qualified shareholder status, but – the words 'qualified shareholder' being simply a part of the expressions 'loans granted (or guaranteed) *by*' and 'equity attributable *to*' – it is only with reference to these latter substantive requirements that timing issues arise.

5. Indirect holdings

An extremely delicate issue, very likely to be clarified (hopefully soon) by a decree or a circular, is whether a qualified shareholder needs to directly hold a stake in the debtor company, or if indirect shareholding is enough. Indeed, Art. 98(3)(c) is worded in such a way – 'a shareholder is qualified when . . .' – that only a direct shareholding would seem to qualify; no matter whether you control the debtor or if your related parties meet the 25 per cent capital threshold: if you do not hold at least a share directly, you are no qualified shareholder (because you are not a shareholder in the first place).[29] True, Art. 98(3)(c)(1) provides for '*directly or indirectly controlling* the debtor company', but there's nothing in it to prevent the indirect control check from being performed on direct shareholders only.

Another reason for this line of interpretation lies in the text of Art. 98(3)(c)(2): when providing that related parties' stakes must also be taken into account for the purpose of computing the 25 per cent stake in the capital of the debtor company, such provision uses a term[30] – 'related parties' stakes *contribute*' – that would awkwardly fit with a situation in which only related parties had stakes in the capital of the debtor company.

Of course, such a doctrine would leave the door open for abuse: if company A holds 100 per cent of company B and this latter holds 100 per cent of company C, company A would not be a qualified shareholder of company C and therefore all loans granted or guaranteed by company A would not be relevant in determining the debt/equity ratio. In other words, whenever a thin capitalization issue could arise, simply interposing an intermediate holding would do away with it.

It is not only on anti-abuse grounds, however, that a mere direct holding requirement should be questioned. Government had been delegated by Parliament to enact the tax reform with the Act of 7 April 2003, n. 80, whose Art. 4(1)(g) targets:

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27 Paolo Ludovici, 'Sui debiti un monitoraggio no-stop', *Il Sole-24 ore* of 16 October 2003, p. 23 (indeed , we must acknowledge that such a view was expressed on the basis of a provisional draft of the thin capitalization rules).

28 Autonomous credit standing, for a discussion of which we make reference to para. 1.8.

29 This issue was also raised by the Italian bankers' Association on the hearing of 7 October 2003.

30 The original Italian text of the provision reads as follows: '*partecipa al capitale sociale dello stesso debitore con una percentuale pari o superiore al 25 per cento, alla determinazione della quale* concorrono *le partecipazioni detenute da sue parti correlate*'.

'loans, granted or guaranteed by a shareholder[31] holding *directly or indirectly* a participation not lower than 10 per cent of the share capital and by its related parties, to be identified on the basis of criteria under Art. 2359 of the Civil Code.'

Even if the provision currently in force has plainly been departing from such guidelines on some issues,[32] it would still be rather unwise – in thoroughly interpreting it – to ignore the fact that the delegating act did provide for indirect holding: Art. 98(3)(c) being somewhat ambiguous in this respect, it cannot be held to have deliberately been departing from such guideline, with the result that it should be construed as allowing qualified shareholder status also in case of indirect holding.

C. Substantive scope with respect to debt

If no qualified shareholder can be ascertained, then thin capitalization rules do not apply and the matter ends here; otherwise, the further step should be taken to assess whether a qualified shareholder (or a related party of his) has been granting or guaranteeing a loan to the corporation.

1. A 'loan'

Article 98(4) of the Income Tax Code provides that 'financing ... is relevant, i.e. loans, cash deposits and any other relation of a *financial nature*'. On this basis, prominent scholars have been holding that trade payables – as well as those arising from compensation for damages and guarantee deposits – are out of the scope of thin capitalization rules;[33] of course, to the extent a debt originally arising as a trade payable eventually becomes a form of financing,[34] a recapture for thin capitalization purposes should take place. It is also worth mentioning that the 'relation of a financial nature' concept is much broader than the 'relation economically qualifying as a financial debt' as originally provided for by the delegating law,[35] with the result that derivatives and guarantee contracts could also be included, which could entail only a mere potential utilization of capital.[36]

The treatment of debentures involves an extremely thorny issue. From a practical point of view, a company could have no clue as to who is the holder of its bearer securities and as a result it could not tell whether such securities should be attributed to a qualified shareholder or not; this has brought the Italian Bankers' Association[37] to hope in an official confirmation that debentures should be considered as out of the scope of thin capitalization rules, due to the autonomous credit standing provision of Art. 98(2)(b).[38] On the other hand, the wording of the provision is quite clear: inasmuch it provides that interest expenses are to be 'computed net of those [already] undeductible under [provisions for excessive bond interest]',[39] it leaves no leeway to hold that bond interest (to the extent it remains deductible) should not be subject to thin capitalization rules.[40] Given the current uncertainty, further developments are extremely likely (and will be most welcome).

Leasing rentals include a financial component[41] and there could be a thin capitalization issue with respect to that:[42] indeed, to the extent the leasing company required a guarantee from a qualified shareholder of the lessee company, such financial component could qualify as a loan and be consequently subject to thin capitalization rules.[43] Scholars have been holding that only financial leasing transactions – i.e. those which end up with the leasing company surrendering ownership of the asset to the lessee – should raise the above

Notes

31 True, the term '*shareholder*' is also used in this setting, but the provision – unlike Art. 98(3)(c) – is worded in such a way as to allow such term a much broader sense, thereby allowing indirect shareholder status.

32 Most notably, the 10 per cent threshold has been raised to 25 per cent and the control requirement – under Art. 2359 of the Civil Code – has been used not only for related parties, but also for assessing qualified shareholder status.

33 Raffaello Lupi, 'Prime osservazioni in tema di Thin Capitalization', *Rassegna Tributaria* 2003, no. 5, p. 1493.

34 Under Italian law, there's no fixed threshold beyond which a trade payable becomes a form of financing; however, there could be significant synergies with directive 2000/35/EC, implemented in Italy with the legislative decree 9 October 2002, n. 231, on which see the circular Assonime of 27 March 2003, no. 15.

35 Act of 7 April 2003, no. 80, Art. 4(1)(g).

36 Franco Gallo, 'Schema di decreto legislativo recante 'Riforma dell'imposizione sul reddito delle società' (Ires) – Audizione informale presso la Commissione finanze della Camera dei Deputati', *Rassegna Tributaria* 2003, no. 5, p. 1661.

37 Letter TR/001191 of 11 March 2004 (minutes of the meeting of 24 February 2004).

38 Reference is made to para. 2.H; we fail to see how such a provision could apply to the extent debentures were underwritten by qualified shareholders (and their related parties). On this issue, see also Giuseppe e Stefano Verna, 'La thin cap, ovvero un grosso rompicapo', *Bollettino Tributario* 2004, no. 3, pp. 178–181, at 178.

39 Reference is made to para. 5.A.1.

40 This contrast has also been noted by Marco Piazza, 'Obbligazioni, sorte incerta', *Il Sole-24 ore* of 31 March 2004, p. 25.

41 Such financial component has been calculated as the difference between the rental(s) for the year and the pro rata cost to the leasing company; thus the 24 April 1998 ministerial decree, providing for details of IRAP calculations: this algorithm (or a similar one) should also be made applicable to calculations for thin capitalization purposes.

42 It could also be argued otherwise; see Gianfranco Ferranti, 'I finanziamenti rilevanti ai fini della ''thin capitalization'' ', *Corriere Tributario* 2004, no. 5, pp. 343–347, at 344.

43 Raffaello Lupi, 'Prime osservazioni in tema di Thin Capitalization', *Rassegna Tributaria* 2003, no. 5, p. 1493.

thin capitalization issue, while operational leasing ones (in which the lessee does not acquire the asset) should not.[44]

A similar line of reasoning could be useful in approaching cash pooling transactions: treatment for thin capitalization purposes could indeed take advantage of the existing rules on the applicability of withholding taxes to cash pooling arrangements. Since the relevant provision[45] states that some 'income from capital ... derived by [certain] non resident subjects ... is non taxable, but for interest and other *proceeds arising from lending money*',[46] it follows that no thin capitalization issue is going to arise where no WHT is levied, while – 'lending money' being tantamount to a 'relation of a financial nature' under Art. 98(4) – imposition of a WHT on a cash pooling arrangement will also have the effect of triggering a loan relevant for thin capitalization purposes. On these bases, it may be held that:[47]

- no thin capitalization issue is going to arise with respect to 'zero balance' cash pooling transactions, in which the Italian company transfers its bank account balance to the 'pooler' company (or gets its overdraft covered in the event of a negative balance) on a daily basis, reciprocal positions being registered in a current account;[48]
- on the other hand, 'notional' cash pooling arrangements are likely to be considered as loans for thin capitalization purposes, to the extent no 'pooler' company and no transfer of balances are involved, but only a virtual settlement of reciprocal positive and negative balances takes place, hence a setoff of interest income and expenses.[49]

2. *'guaranteed' by a qualified shareholder*

Article 98(6) of the Income Tax Code provides that:

> 'debts are considered as guaranteed by a shareholder or a related party of his, to the extent covered by a collateral, personal or de facto security provided by such subjects also by way of courses of action and transactions that, despite not formally qualifying as a guarantee, have an equivalent economic effect.'

Collateral or real securities are the pledge[50] on movable goods and the mortgage[51] on immovable goods; personal guarantees include the fidejussion.[52] All of them are surely within the scope of thin cap rules: not only the kind of income they yield to the guarantor does not matter,[53] but they are relevant even irrespective of whether they yield any income at all or not (e.g. pledging a picture by Rembrandt).[54]

A *de facto* security could be the letter of patronage, which – despite not qualifying as a fidejussion (hence a personal guarantee) from a strictly juridical point of view – may in some circumstances play a similar function in securing a bank loan. A letter of patronage is a statement by the lead parent company, in which it declares to the bank that it owns a control shareholding in the subsidiary asking for a loan, that it will oversee that such subsidiary will fulfil its obligations with respect to such loan and (often) that it will not sell the subsidiary before the loan is repaid.[55]

Courses of action and transactions having an equivalent economic effect are hard to determine: likely future rulings will establish how much so loud a

Notes

44 Tancredi Marino, 'Prime riflessioni sull'introduzione della norma di contrasto all'utilizzo fiscale della sottocapitalizzazione', *Bollettino Tributario* 2004, no. 1, pp. 14–29, at 23.

45 Article 26*bis* of Presidential Decree, 29 September 1973, no. 600. Of course, exemption from WHT – even if not available under domestic law – could anyway be achieved due to the Interest and Royalties Directive (Council Directive no. 49/2003, OJ L 157, 26 June 2003, p. 49); however, Italian thin capitalization rules fall within the scope of Art. 4(1)(a) of such Directive, with the result that exemption from WHT could anyway be denied. See Marcello Distaso and Raffaele Russo, 'The EC Interest and Royalties Directive – A Comment', *European Taxation* 2004, vol. 44, no. 4, pp. 143–154, at 150.

46 'First and foremost, interest and other proceeds arising from loans of money are out of the scope of the exemption, since they serve a money lending purpose. Second, also interest and other proceeds arising from deposits and current accounts are out of the scope of the exemption, to the extent such arrangements are an instrument for a money lending purpose. In particular, the statutory provision under exam aims at leaving as taxable interest and other proceeds arising from arrangements that, despite being like deposit or current accounts contracts from a juridical point of view, are actually exploited in order to foster a money lending transaction'; thus the ruling 27 February 2002, no. 58/E.

47 Gianfranco Ferranti, 'I finanziamenti rilevanti ai fini della «thin capitalization»', *Corriere Tributario* 2004, no. 5, pp. 343–347, at 345 and Tancredi Marino, 'Prime riflessioni sull'introduzione della norma di contrasto all'utilizzo fiscale della sottocapitalizzazione', *Bollettino Tributario* 2004, no. 1, pp. 14–29, at 24.

48 See the ruling 27 February 2002, no. 58/E.

49 See the ruling 8 October 2003, no. 194/E.

50 Article 2784 of the Civil Code states that 'the pledge is established as a guarantee of the obligation by the debtor or by a third party for the debtor'; according to the following Arts. 2786 and 2787, 'the pledge is established through the delivery of the pledged good to the creditor' and 'the creditor is entitled to be paid off with priority on the pledged good'. Also the 'irregular pledge' under Art. 1851 of the Civil Code should be within the scope of this provision.

51 Article 2808 of the Civil Code states that 'mortgage entitles the creditor to seize, also vis-à-vis subsequent buyers, goods tied-up as guarantee of his claim and to be paid off with priority on the price arising from the seizure'.

52 Article 1936 of the Civil Code states that 'fidejussor is the one who, by personally binding himself vis-à-vis the creditor, guarantees for the fulfilment of a third party's obligation'.

53 There's no need to tell 'income from capital' from 'miscellaneous income' or business income, as with the Prodi levy, for which reference is made to para. 5.B.

54 Raffaello Lupi, 'Prime osservazioni in tema di Thin Capitalization', *Rassegna Tributaria* 2003, no. 5, p. 1493.

55 Natale Girolamo, Luca Rossi and Paolo Scarioni, 'La "thin capitalization rule" o regola di "sovraindebitamento"', *Bollettino Tributario* 2002, no. 22, pp. 1616–1621, at 1620.

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bark is followed by a correspondingly severe bite. From a theoretical viewpoint, we cannot but agree with those scholars[56] that hold the economic interpretation of contracts as worthy, to the extent its reach does not extent to entitling lawyers and tax authorities to actually write the law; how this principle can be applied in an actual setting remains to be seen. Of course, a guarantee for thin capitalization purposes exists whenever the contractual relationships involve the possibility for the bank to seize the assets,[57] but then it would also be a guarantee from a juridical point of view:[58] on the other hand, this provision should stop short of deeming a guarantee any situation in which a bank has deposits from a qualified shareholder.

Case study F

Marco is a wealthy individual, as well as de facto sole shareholder of M Srl. When contracting with the bank for a loan to this latter company, the loan manager makes a vague speech about 'being partners in a longstanding relationships' with 'clients of the bank as a whole', while all the time carelessly fiddling with a glossy brochure of the private banking department.

Being a smart guy in a mans world (and having some understanding of commercial banking), Marco guesses that the chances of M Srl securing the loan would be substantially improved by his transferring management of personal wealth to the same bank he is asking the loan from; under the standard wealth management contract, the bank has no power to either withhold or seize the assets in the event a controlled company defaulted on a loan payment.

Lo and behold: the day the transfer takes place, the private banking manager happens to call his colleague in the loans department and by chance the conversation drops on Marco, whose 'commitment with the Bank' is praised and the bank in turn should be 'developing a partnership attitude', also in view of his 'prominence within the local entrepreneurial community'; unsurprisingly, the loan is swiftly granted.

Apart from real-life details, the issue is: does the above 'soft connection' between the wealth management and the granting of the loan amount to a guarantee for thin capitalization purposes?

Undoubtedly, there is a link between the transfer of personal wealth and the eventual grant of the loan; however, in the above situation the bank is not trying to secure collateral (not even *de facto*) for the loan, nor any other guarantee: rather, it is using its loan-granting power as a tool to secure further business for the private banking department. In other words, consideration for the decision to grant the loan is not a further guarantee for the same, but the wealth management fees (as well as fund managers' distribution fees): it is the same cross-selling mechanism applying to a corporate lawyer introducing to the client his firm's tax practice. Taking into account these considerations, the envisaged 'soft connection' should be considered as not amounting to a guarantee for thin cap purposes; therefore, M Srl should not take into account this bank loan when performing thin capitalization calculations with reference to the qualified shareholder Marco.

3. Interest-free loans

Article 98(3)(f) of the Income Tax Code provides that 'interest-free loans ... shall not be taken into account ... provided that the average interest rate ... does not exceed the official reference rate plus one per cent'. The official reference rate (formerly the official discount rate) is set by the Bank of Italy, mirroring the European Central Bank discount rate; since this latter is currently 2 per cent,[59] the relevant threshold is 3 per cent.

The purpose of this provision is that of 'avoiding abusive behaviours that could take place with a shareholder simultaneously granting interest-free and interest-bearing loans, these latter at so high a rate as to compensate the shareholder of the [opportunity] loss suffered with reference to the former'.[60] However, due to the interest rate level chosen, this provision is grossly oversized; not even the most creditworthy of companies can currently obtain financing at less than 3 per cent: how in the world could a shareholder be accomplishing the abusive arrangement envisaged above by asking for slightly more?

The effects of this provision are further exacerbated by the tax authority holding that the average interest rate is not to be computed on all the loans (interest-bearing and interest-free), but on interest-bearing loans only.[61] This means that a qualified shareholder lending a company 100 at a 4 per cent rate and 900 interest-free will cause such company to have 'loans' amounting to 1,000 for thin capitalization purposes, even if the overall rate of the cumulative loan is a nimble 0.4 per cent ... indeed an 'abusive behaviour', but certainly not on the taxpayer's side!

Notes

[56] Raffaello Lupi, *Manuale giuridico professionale di diritto tributario* (Milan, Ipsoa, 2001), p. 244.

[57] A similar issue is dealt with by Raffaele Rizzardi, 'Sulle garanzie determinante la prassi amministrativa', *Il Sole-24 ore* of 14 April 2004, p. 22.

[58] Raffaello Lupi, 'Prime osservazioni in tema di Thin Capitalization', *Rassegna Tributaria* 2003, no. 5, p. 1493.

[59] Bank of Italy, provision 6 June 2003, in the *Official Gazette* of 9 June 2003.

[60] Thus the ministerial report accompanying the tax reform.

[61] *Ibid*., see also Raffaele Rizzardi, 'Finanziatori trasparenti senza doppia tassazione', *Il Sole-24 ore* of 28 January 2004, p. 26 commenting on a tax authority position during the answer session known as 'Telefisco'.

In this setting, a taxpayer could be reckoning that thin capitalization rules only target the level of loans, not that of interest expenses arising from such loans; true, transfer pricing rules apply to the extent an Italian company is borrowing from a foreign related party,[62] but otherwise setting the interest level is a decision enjoying a considerable leeway.

Under these circumstances, a qualified shareholder could decide to provide his company with only so much loan capital as allowed under the debt/equity ratio, but at a much higher interest rate. To the extent the company's thirst for cash could not be quenched by such loans only, a small amount of equity could be provided,[63] thus raising the debt/equity threshold by four times its amount, thereby allowing more loans to be booked without thin capitalization issues arising. Since some shareholders could be fearing dilution, separate classes of non-voting shares or 'payments in capital account' – considered as equity, yet linked to the specific shareholder and refundable to him with much less formalities than a reduction of capital would take – are the likely solution to their needs.

Case study G
A, B and C are the sole shareholders of – respectively – CoA, CoB and CoC; each one of these companies has an equity of 10 and needs money for 80.

A makes a loan to CoA for 80 at an interest rate of 5 per cent: since the debt/equity ratio exceeds 4 to 1, half of interest expenses – i.e. 2 – may not be deducted by CoA.

B makes a loan to CoB for 40 at an interest rate of 10 per cent, plus an interest-free loan for 40: without taking into account this latter interest-free loan, the debt/equity ratio would be within the thin capitalization threshold, but since the average rate of 10 per cent (computed on interest-bearing loans only) exceeds the threshold, then also the interest-free loan should be taken into account, with the result that the debt/equity ratio exceeds 4 to 1 and so half of interest expenses – i.e. 2 – may not be deducted by CoB. C makes a loan to CoC for 40 at an interest rate of 10 per cent, plus a payment in capital account for 40: since payments in capital account are not targeted by the rule, the debt/equity ratio remains within the thin cap threshold and all interest expenses are deductible. Indeed, not only are payments in capital account not relevant as debt: they actually count as equity, so that C could have well been spreading the interest expense of 4 over a loan of 72 (thus achieving a lower 5.5 per cent nominal interest rate), while providing for payments in capital account amounting just to 8.

However, 'payments in capital account' could raise some problems at the time of restitution. Article 47(1) of the Income Tax Code[64] – as amended by the Tax reform – provides that 'no matter shareholders' meeting resolution, an irrebuttable presumption is hereby set, under which earnings and profits of the year and reserves different from capital ones are distributed first'. This means that while loans (both interest-bearing and interest-free) may be repaid without any taxation arising, 'payments in capital account' can be (as a tax-free recovery of basis) only to the extent that there are no retained earnings and profits: otherwise, the amount will be taxed as a dividend. This should not be a big problem for corporate shareholders (which are only taxed on 5 per cent of the dividend amount[65]), especially if they have been opting for the consolidated base taxation regime, under which dividends flow tax-free;[66] on the other hand, individual shareholders – who pay their marginal tax rate on 40 per cent of the dividend amount[67] – could find this consequence quite annoying. Eventually, individual shareholders of companies with high amounts of retained earnings and profits will likely think twice before making 'payments in capital account' *in lieu* of interest-free loans, while shareholders of a corporate nature and those of companies with low retained earnings and profits will still find the game worth playing.[68]

Indeed, it could even be argued that no anti-avoidance issue should arise with respect to the above course of action. First and foremost, to the extent Art. 47(1) of the Income Tax Code deems distributions as being made out of retained earnings and profits, it voids Art. 37*bis*(3)(a) of the 600/73 decree, which indicates as anti-avoidance target 'distributions to shareholders of amounts taken from equity items different from retained earnings and profits'. True, Art. 37*bis*(3)(b) still targets 'contributions to corporations', but then the real issue becomes: thin capitaliza-

Notes

62 Article 110(7) of the Income Tax Code.

63 Since late 1999, the 1 per cent capital duty no longer applies to contributions of cash.

64 See para. 3.1 of the Circular 26/E of 16 June 2004.

65 Article 89(2) of the Income Tax Code.

66 Article 122(1)(a) of the Income Tax Code.

67 Article 47(1) of the Income Tax Code: since the top individual income tax rate is 45 per cent (plus local surtaxes, generally between 1 and 2 per cent), this could amount to an 18 per cent–18.5 per cent effective rate for high income taxpayers. These calculations assume that the qualified shareholder is a holder of a qualified participation for Art. 67(1)(c) purposes, otherwise a 12.5 per cent flat dividend WHT applies: even if this latter quite complex test is different from the one for thin capitalization purposes (most notably, there are no family attribution rules), in most cases a thin capitalization individual qualified shareholder will also be a holder of a qualified participation under Art. 67(1)(c).

68 On the consequences of the distribution to shareholders of capital reserves, see Luca Rossi and Paolo Scarioni, 'La restituzione delle riserve di capitale ai soci', *Bollettino Tributario* 2004, no. 11, pp. 824–828.

tion rules being aimed at discouraging indebtedness towards qualified shareholders when excessive with respect to the equity thereof,[69] an equity contribution can hardly be deemed to be 'aimed at circumventing conditions and prohibitions provided by tax law'. If penalizing debt with respect to equity results in taxpayers providing more equity, this is no avoidance, but precisely what thin capitalization aims at.

4. Timing issues

Article 98(3)(f) provides that 'the average amount of loans ... shall be determined by adding the overall amount thereof as of the end of any day in the business year and then dividing such amount by the number of days in the same business year'. Averaging is thus provided for, since taking into account the amount of loans as of a certain date would have been open to abuse. According to the ministerial report accompanying the tax reform, reference shall be made to the value date, whenever different from the accounting date.

This provision should be construed as to accommodate changes in qualified shareholder status: if a qualified shareholder sells all his stakes on 28 May, loans granted by him should only be computed in the above average amount until 27 May, since from 28 May onwards they are loans granted by a no longer qualified shareholder. In other words, at the end of each day loans shall be added, granted by subjects enjoying qualified shareholder (or related party) status as of the end of the same day: loans granted by former qualified shareholders shall not be taken into account.

D. Substantive scope with respect to equity

Article 98(3)(e) provides that:

> 'accounting net equity shall be taken into consideration, as resulting from the financial statements of the previous business year, including undistributed profit of such year, reduced to take into account:
> 1) receivables as resulting from the asset side of the balance sheet arising from contribution duties still to be performed;
> 2) the book value of own treasury stock.'

A kind of 'adjusted net equity for thin capitalization purposes'[70] is hereby provided for, the adjustments aiming either at neutralising merely nominal net equity components or at curbing possible avoidance schemes.

Obviously, the reduction for contribution duties still to be paid only aims at neutralizing nominal components; from a factual point of view, there is no difference between funding a company for 30 in equity and 70 in debt and providing it with 100 in equity (of which only 30 are actually paid up) and 70 in debt: also this latter situation must fall within the scope of thin capitalization rules. Treasury stock reductions follow the same rationale: if equity for 100 is provided for, but then own shares for 10 are purchased back from the shareholders,[71] the same consequences should follow as if only 90 of equity was provided for; on the other hand, scholars[72] have been arguing that only treasury stock exceeding the Civil Code threshold (hence, to be written off) should be sterilized, but not those held to be sold.

1. Decrease (actually an increase) for losses

Article 98(3)(e)(3) provides that the net equity shall be reduced to take into account:

> 'losses, to the extent the net equity is not restored by way of profits set aside or contributions in cash or in kind within the date the financial statements are approved relating to the second business year after the one in which such losses arose.'

The wording of this provision is indeed puzzling: why is the net equity to be reduced by losses, when a loss by its own nature already reduces the accounting net equity? Of course, no double reduction is provided for, but the provision should be construed as instead allowing a temporary increase of the net equity, in order to sterilize the decrease otherwise caused by the losses.[73] In other words, losses shall only be allowed to (automatically) decrease the net equity, to the extent they are not covered by either later profits or contributions within the relevant date: as a consequence, no (automatic) decrease is allowed to take place before such date, i.e. an increase for 'new' losses must be carried out.

A further issue in this respect is how to allocate profits set aside and contributions where some losses remain; in other words, shall prior losses be covered first, or later ones? FIFO (prior losses covered first) acts in favour or the taxpayer, since later losses can be

Notes

[69] Thus the ministerial report accompanying the tax reform.

[70] This indeed remarkable expression we owe to Tancredi Marino, 'Prime riflessioni sull'introduzione della norma di contrasto all'utilizzo fiscale della sottocapitalizzazione', *Bollettino Tributario* 2004, no. 1, pp. 14–29, at 24.

[71] Under Art. 2357(3) of the Civil Code, a company may not purchase own shares for a face value exceeding one-tenth of the share capital, also taking into account shares held by controlled companies.

[72] Tancredi Marino, 'Prime riflessioni sull'introduzione della norma di contrasto all'utilizzo fiscale della sottocapitalizzazione', *Bollettino Tributario* 2004, no. 1, pp. 14–29, at 26.

[73] This way we interpret the example provided by the ministerial report accompanying the tax reform. See also Aldo Milone, 'Il patrimonio netto rilevante ai fini della thin capitalization', *Il fisco* 2004, no. 26, p. 1-4044.

disregarded for a couple of years (hence, a higher adjusted net equity); LIFO (recent losses covered first) instead acts against the taxpayer: the same losses are covered first, which would anyway be disregarded due to Art. 98(3)(e)(3). The following example shows the different consequences between one situation and the other.

Case facts	Year 1	Year 2	Year 3	Year 4	Year 5
Net equity as of 1 January	600	500	430	580	430
Profit/loss for the year	(100)	(70)	150	(150)	0
Net equity as of 31 December	500	430	580	430	430

Case study H
Calculation of adjusted net equity for thin capitalization purposes:

- in year 1 the net equity of 600 is relevant for thin capitalization purposes;
- in year 2 the net equity of 500 + 100 = 600 is relevant for thin capitalization purposes, since losses are sterilized anyway;
- in year 3 the net equity is 430 + 70 + 100 = 600 under the FIFO method (profit of 150 first cover old losses), while only 430 + 70 + 80 = 580 under the LIFO method (old losses for 20 remaining, which are no longer sterilized);
- in year 4 the net equity of 580 is relevant for thin capitalization purposes;
- in year 5 the net equity of 430 + 150 = 580 is relevant for thin capitalization purposes.

Nothing is provided as to which of these two methods should apply:[74] the ministerial report accompanying the tax reform appears to use LIFO, while worthy scholars[75] have been employing FIFO; however, none of them seem to have realized the issue, let alone consciously addressed it. True, NOLs carried forward are usually utilized with a FIFO method,[76] but NOLs are tax losses, while here we're dealing with accounting losses, so that simply following that rule is not so obvious a solution. Given the current uncertainty, further developments are extremely likely (and will be most welcome).

2. Decrease to avoid the 'layering' of indebtedness

Article 98(3)(e)(4) provides that the net equity shall be reduced to take into account 'the book value or the accounting net equity thereof, whichever the lower, of participations in controlled and connected companies', to the extent these companies are Italian corporations and partnerships, different from banks.

This provision aims at preventing a taxpayer from subdividing the indebtedness through several corporate layers, thus achieving a higher equity in each layer, as the following example shows.

Case study I
A is the sole shareholder of ItaCo, a company with an equity of 10; A wants to purchase a going concern worth 250, by using ItaCo's equity and lending the rest to the company. If ItaCo is funded with 10 equity and 240 debt, the debt/equity ratio being 4/1 means that interest expenses on 200 will not be deductible. ItaCo then borrows 40 from A and incorporates a fully owned subsidiary with an equity of 50; this latter subsidiary then borrows 200 from A and purchases the going concern for 250: since both ItaCo and the subsidiary are just within the debt/equity threshold, no thin capitalization issue would arise and all interest expenses would remain deductible.

In an international setting, the issue has been addressed under three different approaches:[77]

- consolidation, providing for an average debt/equity ratio at the group level (employed by the US and New Zealand);
- upstream sterilization is the one hereby described (adopted by Germany and hence by Italy);
- downstream sterilization, under which the subsidiary's net equity is not relevant to the extent the parent finances the holding with debt (devised by Japan).

The problem with this provision is that tricks like the one above are not fully prevented: as the stretching of indebtedness over multiple corporate layers is performed from a consolidated viewpoint, a provision requiring consolidation of debts and equity would be more effective – admittedly, at a greater administrative cost for both taxpayer and tax authority – in addressing these kind of transactions. Just consider that in the above example under Art. 98(3)(e)(4) ItaCo would be denied all interest expense deductions, but the subsidiary would not be targeted at all: from a consolidated viewpoint, debt for 200 would raise no thin capitalization issue and only debt for 40 would, rather than the other way around.[78]

Notes

[74] Of course, other methods could be employed (e.g. averaging), but at a much higher administrative burden.

[75] Luca Rossi and Paolo Scarioni, 'Appunti in tema di capitalizzazione sottile', *Bollettino Tributario* 2004, no. 2, pp. 95–100, at 97.

[76] Article 84 of the Income Tax Code. Actually, FIFO is not provided by law but – being as a rule the method most beneficial to the taxpayer – is the method used in the vast majority of cases; an exception arises with losses with unlimited carry forward, which are usually exploited last.

[77] See Giovanni Rolle, 'Gruppi multinazionali e thin capitalization', *Il Fisco* 2002, no. 27, p. 10169.

[78] For a thorough discussion of the provision, as well as for case studies involving also situations in which the taxpayer could be penalised, see Luca Rossi and Paolo Scarioni, 'Appunti in tema di capitalizzazione sottile', *Bollettino Tributario* 2004, no. 2, pp. 95–100, at 97–98.

Indeed, ancestors of the provision could be traced to analogous rules in the old dual income tax[79] and net equity tax[80] regulations, so that the persistence of a – somewhat superseded – framework could partly explain for its structure being at times ineffective.

The exclusion of banks is self-explanatory, since loans taken on in the course of a banking business are not to be taken into account for thin capitalization purposes: there would be no purpose in trying to subdivide the indebtedness through several corporate layers when a bank was involved. Also foreign companies are out of the scope of this provision, but the rationale behind this latter exemption is less clear to us: foreign companies are not *per se* out of the scope of Italian thin capitalization rules[81] and – even if they were – they still could be employed in a chain of companies in order to 'water down' the consolidate debt.[82] In the above case study, just imagine ItaCo holding the Italian subsidiary not directly, but through an intermediate Dutch holding company: not even its 40 debt would have a thin capitalization problem.

3. Increase for silent partnerships

According to Art. 98(1), net equity must be 'increased by the amount of equity contributions performed by the qualified shareholder and his related parties pursuant to contracts under Art. 109(9)(b)'; these are the silent partnership – i.e. 'associazione in partecipazione'[83] – and like contracts under Art. 2554 of the Civil Code,[84] to the extent the contribution is different from work and services (according to the ministerial report, also 'mixed' association in participation contracts fall within the scope of this latter provision).

This provision is a consequence of remuneration on such contracts – previously deductible for the associating party and taxable on the associated – now being treated as an undeductible dividend-like payment under the tax reform:[85] since a silent partner is deriving a dividend-like remuneration from the company (i.e. non-deductible), a consistent treatment requires to consider his contribution as equity for thin capitalization purposes also.

4. Timing issues

Since 'the financial statements of the previous business year' are taken into account, one may wonder how to apply thin capitalization rules to the first business year of a company: even if some scholars[86] argue that – due to this issue – the first business year should not be bothered by thin capitalization problems, we still deem a more logical (and definitely more likely) solution would be that of making reference to the initial equity contributions.

Another issue arising in this respect is whether qualified shareholders' stakes are also to be determined with reference to 'the financial statements of the previous business year'. An affirmative answer would mean that a qualified shareholder as of 1 January selling all his shares on 5 January (and having no related party) and then providing a loan to the company would cause the latter some thin capitalization problems; on the other hand, the purchaser of a qualified shareholding on 5 January would have 360 days in which to sink the company with debt without the latter bothering about thin capitalizaiton. On the basis of these considerations, we submit – along with the best scholars[87] – that 'the financial statements of the previous business year' are only relevant with respect to the 'adjusted net equity for thin cap purposes' amount, but shareholders' stakes should instead be determined on a *pro tempore* basis, i.e. by averaging the stakes according to the number of days such stakes are held.

E. The 'overall' check

If no qualified shareholder is determined, then thin capitalization rules do not apply and the matter ends here; the same can be said where no loan (or guarantee) can be ascribed to a qualified shareholder or related party. If there is at least one qualified shareholder and the basic requirement of a loan being attributed to him is fulfilled, then the 'overall' check must be performed.

Article 98(2)(a) provides that thin capitalization

Notes

[79] Article 3(2) of legislative decree 18 December 1997, no. 466.

[80] Article 1(4) of law decree 30 September 1992, no. 394 (converted into law by the 461/92 Act).

[81] Reference is made to para. 3.C. for a discussion of thin capitalization rules and permanent establishments.

[82] It is worth noticing that – under the net equity tax – indirect holding of a domestic company through a foreign one was taken into account instead; see Art. 1(4) of law decree 30 September 1992, no. 394 and the ministerial circular 7/9/870 of 21 April 1993.

[83] Article 2549 of the Civil Code provides that 'under the contract of association in participation the associating [party] assigns to the associated a share in the profits of his enterprise or of one or more businesses, consideration being a certain contribution'; under the following Art. 2553, 'unless provided otherwise, the associated [party] shares in the losses to the same extent he shares in the profits, but losses borne by the associated may not exceed the value of his contribution'.

[84] These are the contract of profit sharing without the sharing of losses, and the one under which a party assigns profits and loss sharing of his enterprise, without any contribution as a consideration.

[85] See by Guido and Andrea Vasapolli, 'L'imponibilità degli utili percepiti dall'associato in partecipazione', *Corriere Tributario* 2003, no. 47, p. 3878 and by the same authors 'I contratti di associazione in partecipazione con associati non residenti', *Corriere Tributario* 2003, no. 48, p. 3962.

[86] Giuseppe Andrea Giannantonio, 'Ancora sulla riportabilità delle perdite in caso di fusione in assenza di costi per prestazioni di lavoro dipendente – Brevi considerazioni a margine di una risoluzione ministeriale e spunti interpretativi ai fini thin cap', *Bollettino Tributario* 2004, no. 9, pp. 662–664, at 664.

[87] Luca Rossi and Paolo Scarioni, 'Appunti in tema di capitalizzazione sottile', *Bollettino Tributario* 2004, no. 2, pp. 95–100, at 96.

rules do not apply whenever 'overall loans under paragraph 4 do not exceed four times the accounting net equity'. Literally, this rule would mean that not all the loans, but only those granted or guaranteed by qualified shareholders (and their related parties) must not exceed a threshold determined as four times the adjusted net equity for thin capitalization purposes: an objective reference to this latter amount would mean that all the net equity would be relevant, not only the stakes thereof held by qualified shareholders (and their related parties). To the extent only qualified shareholders' debt is compared to *all* shareholders' equity, the provision would be a great safe harbour against thin capitalization rules.

That is probably why the ministerial report accompanying the tax reform holds that not all the net equity would be relevant, but only the stakes thereof held by qualified shareholders (and their related parties): this way, qualified shareholders' debt should be compared to qualified shareholders' equity. Anyway, we would highlight that – even under this restrictive viewpoint – all qualified shareholders' equity would be relevant, irrespective of how many of them are actually granting loans or not; this could lead to some indeed remarkable consequences, as the following example shows.

Case study J
ItaCo has 4 corporate shareholders: A holds 28 per cent (so a qualified shareholder for thin capitalization purposes), while B, C and D hold 24 per cent each. ItaCo's equity is 100 and A grants a loan for 200: since there is no other qualified shareholder, the overall check gives a result of 200/28 = 7.14 exceeding the thin capitalization threshold of 4/1, so that ItaCo has a thin capitalization problem.

Let us now assume that B purchases C, so that a new qualified shareholder arises, with an equity stake of 48 per cent: rather than increasing ItaCo's thin capitalization problems, this is going to solve them. Assuming neither B nor C have been granting relevant loans to ItaCo, the overall check now gives a result of 200/76 = 2.63 within the thin capitalization threshold of 4/1, so that ItaCo no longer has a thin capitalization problem.

Article 4(1)(b) of legislative decree 344/03 provides that – for the first tax period starting on or after 1 January 2004 – the debt/equity ratio is increased to five to one; this provision is worded so as to apply only to the 'per-head' check. However, the ministerial report accompanying the tax reform holds that the 'overall' check threshold shall also be increased for the first tax period. The same ministerial report also states that the net equity must be increased by the amount of equity contributions performed by qualified shareholders under silent partnership contracts, again something that from a literal interpretation should only apply to the 'per-head' check.[88]

F. The 'per-head' check

If the debt/equity ratio is not exceeded under the overall check, no thin capitalization issue arises. To the extent the threshold is surpassed, then the same calculation must be performed for each qualified shareholder group (i.e. the qualified shareholder and its related parties). It is quite easy to acknowledge that if no qualified shareholder exceeds the debt/equity ratio on a standalone basis, the overall check will return a result within the threshold; on the other hand, this means that if the overall check returns a result above the threshold, then at least one qualified shareholder exceeds the debt/equity ratio on a standalone basis.

The purpose of the 'per-head' check is twofold:

- to find out which qualified shareholders actually raise a thin cap issue for the company, and
- to determine the extent to which such issue is actually going to make interest expenses undeductible.

Once the amount has been established by which the average sum of loans granted by a qualified shareholder exceeds four times the adjusted net equity thereof, we can leave the balance sheet behind (with debt and equity) and go to the income statement to eventually deal with interest expenses.

G. Determining the non-deductible part of interest expenses

Article 98(3)(g) provides that:

> 'interest expenses on excessive indebtedness are calculated by applying to the latter an average interest rate corresponding to the ratio between the overall interest expenses accrued in the business year on loans granted by the qualified shareholder and the average amount of such loans.'

Nothing is provided as to how to apportion such interest flow between a qualified shareholder and a related party: an essential task, given the constructive dividend treatment. Worthy scholars[89] hold that apportionment should be made by using accrued interest as a driver, as the following example shows.

Notes

[88] See the article by Rossi and Scarioni cited in the previous footnote, at 100.

[89] *Ibid.*, at 99.

Case study K
ItaCo has a qualified shareholder A granting a loan for 100 at an interest rate of 4 per cent; B (not a shareholder of ItaCo on his own right) is a related party of A and grants ItaCo a loan of 200 at an interest rate of 3 per cent. Assuming the net equity attributable to A is 30, then the debt/equity threshold is 4*30 = 120, so that loans for 300 result in excessive indebtedness for 180. Interest expenses on such excessive indebtedness shall be computed as follows:

+ interest expenses accrued on A's loan	100*4 per cent =	4
+ interest expenses accrued on B's loan	200*3 per cent =	6
= overall interest expenses accrued	10	
/ overall loans granted by A and B	300	
= average interest rate	3.33 per cent	

Applying this average interest rate to the excessive indebtedness of 180 we find out that ItaCo may not deduct interest expenses for an amount of 6. In order to apportion such interest flow between A and B, the solution submitted uses as a driver interest accrued of – respectively – 4 and 6, so that A ends up with a constructive dividend of 6*4/10 = 2.4 and B with 6*6/10 = 3.6.

An alternative approach would use the amount of debt as a driver to apportion the interest flow; given the case facts of the previous example, the interest flow of 6 would be split as follows: A gets a constructive dividend of 6*100/300 = 2 and B of 6*200/300 = 4. The rationale behind this approach is that interest is not re-qualified as dividend on its own right (i.e. at its own rate), but only as a consequence of excessive debt being considered as equity.

H. Safe harbour provision for autonomous credit standing

Article 98(2)(b) provides that thin capitalization rules do not apply whenever 'the debtor ... proves that the amount of loans ... is justified by its own autonomous credit standing and consequently such loans would have been granted also by third parties having as sole guarantee the corporate assets'.

In future years, this is likely to become the trickiest provision in the thin capitalization family, the one which most rulings will be asked on. As for now, the way an autonomous credit standing shall be proved can best be described as 'open to debate'. Some scholars[90] argue that an appraisal by a chartered accountant, certifying that the actual value of the enterprise exceeds loans granted by (qualified) shareholders, is valid proof. This would mean that no conflict of interest would arise in the event the chartered accountant also provided (tax) consulting services to the company and that the tax authority would yield to his judgment: to hold either is wishful thinking. We side with those scholars[91] that – sharing our doubts – argue that a bank judgement should be relevant for these purposes: undoubtedly, a loan by a shareholder is justified by the company's autonomous credit standing, to the extent a bank credit facility[92] lies unexploited for a corresponding amount.

Anyway, the provision leaves out in the cold those companies that have to apply for loans to their shareholders, precisely because they no longer autonomously enjoy a credit standing high enough to justify a third party loan:[93] thus, an already financially unstable company will also have to cope with non deductible interest expenses.

Leverage buyouts raise an extremely interesting issue in this respect: when a qualified shareholder pledges the same shares of the company receiving the loan, is the loan justified by an autonomous credit standing of such company? Worthy scholars[94] have been arguing that – of course to the extent no recourse is allowed to the shareholder's personal liability – a pledge on the shares of the debtor company is no further guarantee than the latter's corporate assets, with the result that the autonomous credit standing safe harbour should apply. We cannot but agree with them.

I. Constructive dividend

An extremely important consequence of thin capitalization rules is that interest paid by the debtor company

Notes

[90] Giuseppe and Stefano Verna, 'La thin cap, ovvero un grosso rompicapo', *Bollettino Tributario* 2004, no. 3, pp. 178–181, at 178.

[91] Tancredi Marino, 'Prime riflessioni sull'introduzione della norma di contrasto all'utilizzo fiscale della sottocapitalizzazione', *Bollettino Tributario* 2004, no. 1, pp. 14–29, at 28.

[92] The problem is that no bank will ever start a credit facility inquiry, knowing that the purported borrower only wants to gather evidence for thin cap purposes; on the other hand, a credit facility does not come for free and leaving it unexploited just for taxation purposes is no sound business judgment altogether. A 'soft' – i.e. non-committing – affirmative answer by the bank is not enough, according to Raffaele Rizzardi, 'Deroga difficile sulla thin cap', *Il Sole-24 ore* of 14 April 2004, p. 22.

[93] Giovanni D'Abruzzo, 'Thin capitalization rule alla difficile prova del principio di non discriminazione e del sindacato di ragionevolezza', *Bollettino Tributario* 2003, no. 22, pp. 1618–1629, at 1629.

[94] Ezio Maria Simonelli, 'Il pegno delle azioni come garanzia da cui emerge la 'autonoma capacità di credito' della società finanziata'; Lorenzo Barbone, 'Il pegno sulle azioni come prova della autonoma capacità di credito della società'; Raffaelo Lupi, 'Un modo per ridurre alcune distorsioni della Thin Cap'; Sergio Marchese, 'Il doppio pegno nel leveraged buyout e la sussistenza dell'esimente a prescindere dagli accordi sul diritto di voto', all of them published in *Dialoghi di Diritto Tributario* 2004, no. 1, pp. 47–56.

– to the extent non deductible in the hands of this latter – will be treated as a dividend in the hands of the payee.[95] This only applies to loans directly granted by a qualified shareholder or a related party: when a guarantee is being provided, instead, no constructive dividend will arise.

1. Accrual basis versus cash basis

As a rule, dividends are taxable on a cash basis, even when forming part of business income, which is otherwise taxable on an accrual basis.[96] The issue therefore arises as to whether interest income from a subsidiary – to the extent this latter does not deduct the corresponding interest expenses due to thin capitalization rules – should be taxable in the hands of the parent when it accrues or only when it is actually paid. The following scenarios could be envisaged:[97]

- accrual basis for both taxation of the income item and exemption of the relevant part thereof (i.e. 60 per cent for an individual, 95 per cent for a corporation or 100 per cent in case of consolidated base taxation);
- taxation of the income item on an accrual basis and exemption of the relevant part on a cash basis (this would entail a possible unpleasant tax anticipation effect);
- cash basis for both taxation of the income item and exemption of the relevant part thereof (this latter solution is favoured by most scholars).

2. WHT issues

Withholding taxes create a thorny issue: since at the time of payment it is impossible to know whether and to what extent the amount will be re-qualified as a dividend, scholars[98] have been arguing that for withholding tax purposes the interest payment should anyway be treated as interest and the Italian Banking Association[99] agrees on this statement.

After the end of the business year, the borrowing company will state the definitive constructive dividend amount in the withholding agent certificate, following which its qualified shareholders will be able to correctly tax the amounts received and claim deductions for any withholding taxes suffered.[100]

3. Corporate governance issues: beggar thy neighbour shareholder

Inasmuch some form of exemption on the constructive dividend counterbalances the non-deductibility of interest expenses, the system does strive for consistency. However, the sensible (tax) lawyer should be wary that not necessarily the subject suffering from interest expenses being non-deductible is the very same subject relieved by way of a constructive dividend exemption.

Case study L
A company has four shareholders (none of which is a related party to another): A, B and C each hold 24 per cent in terms of both capital and voting rights, while D holds the remaining 28 per cent and so is the sole qualified shareholder for thin capitalization purposes; also assume that every shareholder heavily provides the company with debt financing. On one hand, interest expenses on loans granted by A, B and C are always deductible in the hands of the company (so that also shareholder D indirectly benefits from their deductibility), while remaining fully taxable as interest in the hands of A, B and C (and shareholder D is not going to suffer from this taxation). On the other hand, to the extent they exceed the set debt/equity ratio interest expenses on the loan granted by shareholder D are not deductible in the hands of the company (so that indirectly shareholders A, B and C also suffer from their non-deductibility), while enjoying some form of exemption as constructive dividend in the hands of shareholder D (who is not going to share such benefit with the others).

The above example shows that qualified shareholders could eventually be free-riding on the constructive dividend issue: while non-qualified shareholders will be forced to bear their share of footing the interest expense non-deductibility bill, only qualified shareholders will enjoy exemption on the constructive dividend.

Of course – even if stemming from a tax provision – this is a corporate governance issue and as such our corporate lawyer friends are better placed to cope with it. As tax lawyers, we would envisage two possible kinds of contractual solution to the above issue:

Notes

[95] Articles 44(1)(e) and 89(2) of the Income Tax Code.

[96] Article 89(2) of the Income Tax Code.

[97] Aldo Milone, 'La rilevanza dell'assimilazione delle remunerazioni indeducibili ai dividendi', *Corriere Tributario* 2004, no. 26, pp. 2026–2031, at 2029.

[98] Marco Piazza, 'La thin capitalization perdona all'estero', *Il Sole-24 ore* of 31 March 2004, p. 25 (but we disagree with his holding that non resident subjects shall suffer the final interest WHT); indeed, para. 4.2 of the 16 June 2004, Circular 26/E states that interest WHTs only apply temporarily.

[99] Letter TR/001191 of 11 March 2004 (minutes of the meeting of 24 February 2004).

[100] Gianfranco Ferranti, 'Interessi, conti a fine periodo', *Il Sole-24 ore* of 20 April 2004, p. 28.

- *Ex post*, under which any loan-providing qualified shareholder will be required to refund[101] the company either the latter's tax burden caused by interest expenses resulting non deductible, or the tax relief enjoyed by the shareholder due to the exemption of the constructive dividend;[102]
- *ex ante*, under which a lower interest rate will be provided for qualified shareholder loans, to the extent exceeding the set debt/equity ratio on the basis of provisional thin capitalization computations.

Since none of the above solutions looks simple and straightforward, a very likely outcome is that – every time corporate governance issues are at stake – the parties will try to avoid the application of thin capitalization rules, by turning to more equity financing.

3. Tax treaty issues

The main purpose of tax treaties is to try and avoid double taxation of taxpayers engaged in cross-border operations. It is unfortunate that anti-avoidance legislation designed to prevent and neutralize the shifting of financial flows towards low tax jurisdictions or other harmful cross-border operations, may in fact cause double taxation to occur. Thin capitalization rules may indeed trigger double taxation in some occasions: therefore, a compatibility analysis with tax treaties is relevant each time a thin capitalization rule is at stake.

A. Economic and juridical double taxation

Whenever the interest paid on a loan by a borrower resident in one country (the source state) is deemed non-deductible therein according to its domestic thin capitalization rules, while the same interest is taxed in the hands of the associate recipient – the lender – on the basis of tax jurisdiction rules of its country (the residence state), an economic double taxation issue may arise.

At a first sight, this issue does not require the analysis of thin capitaliztion rules compatibility with tax treaties since, usually, tax treaties deal with and try to solve juridical double taxation matters. Nonetheless, some thin capitaliztion rules[103] not only disallow interest deduction in the source country (if the debt funding exceeds a given debt/equity ratio) but also re-characterize – as Italian thin capitalization rules of Art. 98 do, read in conjunction with Arts 44(1)(e) and 89(2) of the Income Tax Code – the interest paid as a dividend so that the withholding tax levied on the latter create a juridical double taxation issue and again a tax treaty compatibility analysis is recommended.[104]

A thorough study of the issues of compatibility of Italian thin capitaliztion rules with tax treaties would require an analysis of Italian treaties, in particular those Articles resembling Arts 9, 10, 11, 23 and 24 of the OECD Model Convention,[105] since thin capitalization rules may to a certain extent create some treaty issues such as transfer pricing and non-discrimination questions.[106] In the present article we will focus on the two following aspects:

- classification of the interest hit by thin capitalization rules according to treaties' distributive rules and residence state reaction to the re-characterization of interest as a dividend according to Italian domestic (source) rules;
- Italian thin capitalization rules and PE.

B. Re-characterization as a dividend

Even when an 'interest payment' arises at first sight between two associated enterprises, according to treaties resembling the OECD Model Convention wording it is fair to avoid the idea of a 'plain vanilla' case of interest (thus excluding re-characterization as a dividend), at least where certain kind of shareholder debt-financing – e.g. participating loans – are involved and surely where thin cap rules have been leading to such re-characterization.

In those cases, the OECD Model provisions for interest and dividend payments are worded in such a way, which does not help in identifying a clear cut between the two applicable rules. The underlying question in these situations would be: should we treat

Notes

[101] Gross-up clauses will further complicate the issue, as in all likelihood the refund will be taxable in the hands of the company and deductible in those of the shareholder. The scope of Art. 118(4) of the Income Tax Code – providing for non-recognition of consideration for tax advantages – is indeed limited to the consolidated tax base regime provided by Arts. 117 to 129 and the absence of a corresponding provision for thin capitalization purposes means that a refund must be recognized for tax purposes.

[102] The choice between the two refund benchmarks will indeed be a quarrelsome corporate governance issue by itself.

[103] For an overview of the thin cap rules existing in various tax jurisdictions, see Various Authors, 'International aspects of thin capitalization – National Reports', *Cahier de Droit Fiscal International*, vol. LXXXIb (Kluwer, The Hague, 1996).

[104] Among thin capitalization rules that do not provide for a re-characterization of the interest as a dividend (at least for withholding tax purposes), Australia, Canada, France. In these countries, juridical double taxation issues do not arise since the interest will be treated as such by both the source and the residence States. On this point, see John Avery Jones *et al.*, 'Credit and Exemption under tax treaties in cases of differing income characterization', *Diritto e pratica tributaria* 1996, no. I, p. 774.

[105] For an overview on the interrelation between these OECD Model Conventions Articles and thin capitalization rules see Cristiano Caumont Caimi, 'Treaty aspects of thin capitalization', *Diritto e pratica tributaria internazionale* 2003, pp. 417–458.

[106] In this respect, for the analysis of the former thin capitalization rule in an earlier draft of the Italian tax reform, see Raffaele Russo, 'International Aspects of the Proposed Corporate Tax Reform – A Comment', *European Taxation* 2003, vol. 43, no. 9, pp. 304–319, at 316.

interest re-characterized as profits according to domestic thin capitalization rules as remunerations depending on profits and thus as a 'dividend' for treaty purposes, or should we still consider those payments as interest? How can we reconcile the debt claim character of Art. 11 and the corporate right requirement of Art. 10(3)[107] of the OECD Model Convention, according to which a dividend payment would arise? The answer to the foregoing questions is not easy, but it certainly has some relevance, given the different impact on withholding tax rates and relief from juridical double taxation once the choice for dividends or interest definition is made in tax treaties.

1. *Sharing the entrepreneurial risk: the border line*

If we agreed on the idea that interest deriving from a debt claim can be qualified for treaty purposes as a dividend, according to the main literature,[108] only insofar as the lender shares the entrepreneurial risk of the borrower and has a right to participate in year profits and liquidation proceeds (this is what the concept of 'corporate right' would require and what might happen with participating loans), then we would conclude that interest from thin capitalization rules may not always be re-characterized as a dividend for treaty purposes, at least in all those cases where the interest payment is not made conditional on profits derived by the borrower and where the entrepreneurial risk is not shared by the lender.

Notwithstanding the above, we wonder whether there are other cases where re-characterization of interest as a dividend according to domestic law may also give rise to dividend treatment for treaty purposes. In other words, if a debt claim arises but the interest payment on the loan is not dependant on the entrepreneurial results (as participating loans are), should we conclude that the interest paid on such a loan does not fit the dividend definition according to Art. 10(3) of treaties resembling the OECD Model Convention? Does the wording of Art. 11(3) exclude the applicability of Art. 10(3)?

2. *Interaction between Articles 10(3) and 11(3) of the treaties and priority over domestic law*

The interaction of Arts 10(3) and 11(3) of the OECD Model Convention is always a controversial issue[109] in international tax law. Nonetheless, the analysis of the two rules is required in order to understand whether interest and dividends under a treaty interpretation are two autonomous definitions that prevail over domestic tax law rules and prevent reversion to domestic law definitions of dividends including the interest as re-characterized due to thin capitalization rules.

First of all, we submit that since treaty law may only restrict domestic law, treaty definitions of dividends would allow an interest re-characterization as a dividend only to the extent that the Italian thin capitalization rule provides so and insofar as a treaty definition does not exclude it. Thus, the starting point of the analysis should be the wording of thin cap rules as provided for by Italian legislation and, subsequently, the analysis of Italian tax treaties to see whether they restrict this type of legislation.

If we look at the wording of Arts. 44(1)(e), 89(2) and 98 all together, we may see that the re-characterization of the interest on the excess debt as a dividend is quite clear (such re-characterization applying only to interest on loans granted by qualified shareholders and their related parties, but on the other hand not applying to loans simply guaranteed by them); what still remains dubious is whether under Italian treaties recourse to domestic law may be made to obtain such a re-characterization. In order to do so, tax treaty interpretation rules require a complex and strict procedure, according to which recourse to domestic law is allowed only if the context (of the treaty) does not otherwise require, i.e. only to the extent that an autonomous definition of dividend or interest does not arise in the treaty itself.[110]

A possible way out to solve the problem could be that already exploited by other countries' treaty practice. Germany's Double Tax Convention (DTC) with US of 1989 and Turkey's DTCs provide a possible solution by using particular definitions of dividend and interest. Those wordings remove a strict and autonomous treaty concept of the terms interest and dividends and allow recourse to domestic law to re-classify interest as dividends where needed.[111] In these cases there is leeway for domestic law to access treaty definitions and to integrate them. The same result could be achieved by adopting a definition of dividends resembling that of Art. 10(3) of the OECD Model Convention, except for an amendment consisting of

Notes

[107] According to Art. 10(3) of the OECD Model Convention, the dividend definition includes also '*corporate rights* subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident'.

[108] See Klaus Vogel, *Double taxation conventions* (Kluwer, London, 1997), p. 651, m.no 189.

[109] Please see in this respect the OECD report *Thin capitalization* 1987. The report highlights the need to avoid a narrow interpretation of Art. 10(3) (paras. 56–60) and to remove the danger of ambiguity or overlap between the types of income dealt with respectively by Arts. 10 and 11 (para. 85c).

[110] Art. 3(2) of the OECD Model Convention. Although compatible with German treaty practice – and the Italian thin capitalization rule is German in imprinting – we do not feel this clashes with the interpretation provided by John F. Avery Jones *et al*., 'The Interpretation of Tax Treaties with Particular Reference to Art. 3(2) of the OECD Model', *British Tax Review* 1984, nos. 1 and 2: we submit that no univocal conclusion can be drawn under Italian law that interest re-characterized as dividend arises from 'corporate rights', thereby entering Art. 10(3) via Art. 3(2). While we agree that it is the law of the source state (i.e. Italy) that should apply under the circumstances, it is precisely because of such law that the Treaty definition of dividend cannot be taken for granted.

[111] Klaus Vogel, *Double taxation conventions* (Kluwer, London, 1997), p. 743 m.no 73 and p. 683 m.no 226.

the deletion from the text of the word 'corporate' as suggested by some scholars.[112]

3. Italian treaties in practice

So far, Italian treaties do not follow a consistent pattern as far as the wording of the dividend definition is concerned, so that an interpretative issue as to whether to refer to domestic law definitions will still arise in some cases. In the most recent DTCs Italy has concluded with other countries, (e.g. Italy-France and Italy-Germany, effective since 1992 and 1993 respectively), the deletion of the term 'corporate' as suggested above allows recourse to the domestic law definition of dividends thus including the interest as re-characterized by thin cap rules. In contrast to this, it is our opinion that the older DTCs (e.g. Italy-Ireland and Italy-Malaysia effective since 1967 and 1977 respectively) including the reference to 'other corporate rights' create the interpretative issue already discussed, leaving some room for the access to the domestic law definition of dividends into treaties (catching the interest re-characterized by thin capitalization rule) only insofar as the lender shares the entrepreneurial risk of the borrower, i.e. where he has a right in both ordinary profits and liquidation proceeds.[113]

This means that where Italian thin capitalization rules apply (i.e. to the extent all the conditions provided by Art. 98 are fulfilled), in case of a foreign lender resident in a country that has a DTC with Italy, there is not always a mandatory requirement to consider the interest paid by the Italian borrower as a dividend, even if interest is re-characterized as such according to source (Italian) domestic rules.

Consequently, the interest withholding tax will still be applicable on the cross-border interest paid, unless, as above highlighted:

- the foreign lender has a 'corporate right' in the borrower and the Italian treaties dividend definition resembling the OECD Model Convention is deemed applicable due to a sharing of the entrepreneurial risk in the borrower; or
- the Italian treaties' definition of dividends, departing from the OECD Model Convention definition of Art. 10(3), which on one hand reverts to domestic law of the source state and on the other hand does not include the wording 'corporate rights', with the result that the treaty would not restrict the domestic law re-characterization of the interest as a dividend.

In either of these two latter cases, the treaty ceiling on dividend WHTs should apply to the interest as re-characterized under domestic law. The practical issue to be solved is whether the domestic dividend WHT (as lowered by treaties if any) is applicable on the amount of interest (re-characterized as dividend) on the part of the loan exceeding the debt/equity threshold (4/1) in the borrowing Italian corporation, or on the entire interest paid by the borrower. In our opinion, both a literal and a systematic interpretation of the wording of Art. 98 would suggest the adoption of the former approach and thus a dividend WHT might apply only to the interest on the portion of the relevant debt exceeding the debt/equity ratio.[114] Of course, since at the time of payment it is impossible to know whether and to what extent the amount will be re-qualified as a dividend, only refund procedures will be available in the event the dividend ceiling was lower than the interest one (with respect to direct application of the reduced treaty rate).

Italian thin capitalization rules and the re-characterization of the interest as a dividend also play an important role for the application of the Parent-Subsidiary Directive. In this respect, we deem that, where all the requirements of the Directive are met[115] and in cases where interest payments are treated as dividend according to Italian thin capitalization rules, Italy should refrain from levying a withholding tax at source, since that taxation is prohibited under the Parent-Subsidiary Directive.

Finally, some scholars[116] have also pointed out that such a re-characterization of the interest as a dividend should not be applicable to foreign lenders, due to a clarification in the technical ministerial report on the interpretation of the legislative decree 344 of 2003 (introducing the new corporate income tax, thus thin capitalization rules). According to this line of reasoning, the extension of the re-characterization to non-residents would trigger issues of EC law compliance.

Notes

[112] F.C. de Hosson, 'Verdragsrechttelijke aspecten van de Thin Capitalization problematiek', in *Eenvoud en doeltreffendheid* (Deventer, 1987), p. 99.

[113] We include here below the dividends definition examples of Italy-Germany and Italy-Ireland in order to show the different wordings.
Italy-Germany (effective since 1 January 1993).
'The term "dividends" as used in this article means: (a) dividends paid on shares, including income from shares, "jouissance" shares or "jouissance" rights, mining shares, founders' shares or other rights, not being debt-claims, participating in profits (including income from participations in limited liability companies); and (b) other income which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident, and, for the purposes of taxation in the Federal Republic of Germany, income of a silent partner in the sense of the German tax laws from his participation as such in a commercial enterprise and distributions on certificates of an investment fund.'
Italy-Ireland (effective since 1 January 1967).
'The term "dividends" as used in this article means income from shares, "jouissance" shares or "jouissance" rights, mining shares, founders' shares or other rights, not being debt-claims, participating in profits, as well as income from *other corporate rights* assimilated to income from shares by the taxation law of the State of which the company making the distribution is a resident.'

[114] Along this line of interpretation see also Raffaele Russo, 'International Aspects of the Proposed Corporate Tax Reform – A Comment', *European Taxation* 2003, vol. 43, no. 9, pp. 304–319, at 310–311.

[115] Reference is made to para. 4.E. below.

[116] Marco Piazza, 'La thin capitalization perdona all'estero', *Il Sole-24 ore* of 31 March 2004, p. 25.

4. The residence state's relief

For the sake of clarity, however, we also deem that – the main purpose of tax treaties being to avoid (juridical) double taxation – the issue herewith discussed of the 'consequences on tax treaties' distributive rules of the interest re-characterization as a dividend' should now be downsized and approached under a simpler 'relief application' level. Indeed, the application of Art. 23 of the OECD Model Convention and its Commentary as modified in 2000 will ensure that the interest, even if re-characterized as a dividend by the source state, should not be subject to double taxation.

As a matter of fact, according to those amendments,[117] even if the source state (i.e. the borrower's) domestic rules are in conflict with those of the residence state (i.e. the lender's), as far as the re-characterization of the interest as a dividend is concerned, the state of residence should for treaty purposes grant a relief – either exemption or credit under Art. 23A or B – to the extent the source state is taxing in accordance with the provisions of the convention and irrespective of the qualification of the consideration received by the lender (i.e. a dividend or an interest). Consequently, no juridical double taxation will arise in this case. Therefore, as already highlighted by some scholars,[118] we may conclude that tax treaty provisions equivalent to Art. 23 of the OECD Model Convention should be interpreted – leaving aside static and ambulatory approach treaty interpretation issues – as granting a relief in the residence state of the lender, in relation to the source state's taxation on the basis of thin capitalization rules applied to the borrower. The relief has to be granted even if the thin capitalization rule provides for a re-characterization of the interest, as long as the latter is in compliance with the arm's length principle[119] and even if the residence state does not itself consider that payment of interest as a dividend.

C. Italian thin capitalization rules and PE

Another issue to be analysed is that of the applicability of Italian thin capitalization rules to a permanent establishment (PE) through which a foreign company carries on activities in Italy.

At a first glance and from a literal interpretation of the wording of Art. 98 of the Income Tax Code, the thin capitalization rule does not seem to be applicable to PEs, since it refers to the 'equity' of the borrower in order to determine the debt/equity ratio above which the interest is not deductible. Indeed, when dealing with PEs one usually refers to the endowment fund of a PE, so that the concept of equity used in this context is not clearly applicable to PEs as well. Nonetheless, it is our opinion that the rule also applies to PEs, since Art. 152 of the Income Tax Code – in order to determine the PEs' taxable income – makes reference to the entire set of rules of the Code[120] applicable to companies (thus including also Art. 98, i.e. the thin capitalization rule) and certainly because the lack of such application would trigger EC law compatibility issues.[121]

If the rule is also applicable to PEs, one question arises as to whether – in order to determine the debt/equity ratio, above which the interest is not deductible in Italy – reference must be made either to the PE's endowment fund or to the head office equity. With this respect, we are not aware of any interpretation provided by tax authorities in EU countries adopting thin capitalization rules and such a clarification would be welcome in order to provide taxpayers with more certainties in this field.[122] In Italian law, a possible suggestion could be found in the repealed provision on net equity taxation (*Imposta sul patrimonio netto*) and the following implementing ministerial decree.[123] According to such rules the taxation on net equity was applicable both to companies and PEs: reference had to be made to the balance sheet or in PE cases (PEs usually have no balance sheet) to the accounting ledgers, in order to build up a 'deemed equity' on the basis of both the endowment fund and the other available elements of the PE's business. The real issue arises of course when a PE pays the interest. We analyse here below three possible cases with respect to the interaction between the rule of Art. 98 and Italian PEs of foreign companies.

Notes

[117] Please see paragraphs 32.3 and 32.4 of the OECD Commentary on Art. 23 (part E – Conflicts of qualification).

[118] John Avery Jones *et al.*, 'Credit and Exemption under tax treaties in cases of differing income characterization', *Diritto e pratica tributaria* 1996, no. I, p. 774.

[119] The compliance with the arm's length principle is required, since according to Art. 23 the income derived in the residence state and for which relief will have to be granted, must be taxed by the source state 'in accordance with the provision of the convention'. Among those provisions, Art. 9 requires that transactions between associated enterprises must comply with the arm's length principle.

[120] Article 152 refers to section I of head II of title II of the Italian Tax Code, which includes Art. 98.

[121] Please see below para. 4.B. for EC law possible issues deriving from PE exclusion from the thin capitalization rule.

[122] Hansohn van den Hurk and Bouker Wagenaar, 'The far reaching consequences of the ECJ decision in Bosal and the response of the Netherlands', BIFD 2004, no. 6, pp. 269–278, at 276. The authors highlight the need for an addressing clarification on the point. In the Netherlands the thin capitalization rule applies only to foreign PEs of Dutch companies and not the other way around for Dutch PEs of foreign companies. In the former case the need of such application is justified in order to avoid a higher exemption in the Dutch HO taxation.

[123] Article 1(1) of law decree 30 September 1992, no. 394 (converted into law by the 461/92 Act) and Art. 2(1) of the ministerial decree of 7 January 1993.

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1. *A foreign parent company lends money to an Italian subsidiary, the loan forming part of the assets of the parent's Italian PE*

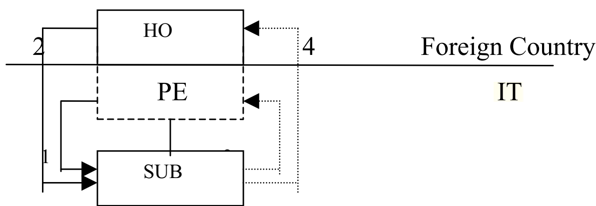

Figure 1

In this first scenario the following considerations may be made.

(a) Obviously, the PE and the head office (hereinafter referred to as HO) represent the same legal entity, so that in order to understand whether the debt-equity ratio is exceeded (as required by Art. 98), both the loans directly granted by the HO to the subsidiary (if any, see no. 2 in figure 1) and those granted through the PE (no. 1 in figure 1) to the subsidiary will be taken into account to calculate the debt-equity ratio.
(b) Following the same line of reasoning, it does not matter whether and to what extent the holding in the subsidiary forms part of the assets of the PE: overall equity attributable to the parent (directly and through a local PE) is relevant for debt-equity ratio purposes.
(c) To the extent that the loan to the subsidiary is attributable[124] to the PE, the interest paid by the subsidiary will not be subject to withholding tax (no. 3 of figure 1).
(d) Where the loan is directly attributable to the HO, Italian domestic law provides for a force of attraction principle under which the interest falls within the scope of the income taxable in the hands of the PE, so that, again, no withholding tax on gross interest amount would apply and Italy could tax that interest on a net basis as PE's profit (no. 4 of the figure 1);[125] consistently with such principle Italy made a reservation on the commentary on Art. 11 of the OECD Model Convention.[126] However, Italy does not avail itself of such reservation in most of actual tax treaties,[127] with the result that in practice the OECD Model Convention ordinary pattern is followed and no force of attraction applies.[128]

2. *An Italian PE receives the money that the HO borrows from the shareholder Xco*

The interest-bearing loan has an economic link with the PE, i.e. it has been contracted for the requirements of that establishment and the interest is borne by the latter. We assume that the PE's endowment fund is 200. Xco owns a 30 per cent participation in the HO whose equity is 2000. There are no other qualified shareholders. The loan is granted for an amount of 1000. The interest paid on the loan is 100 (borne at PE level).

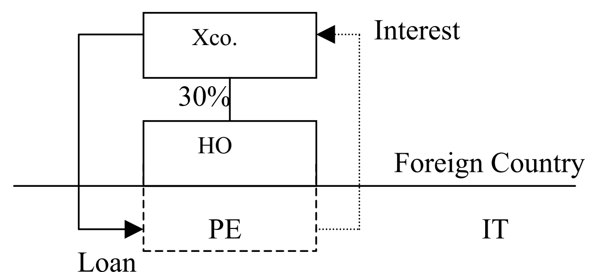

Figure 2

In this different scenario the following applies.

(a) As long as the loan is granted for the benefit of the PE (i.e. the interest is deemed to be borne and paid by the latter according to the interpretation provided for by paras. 25 *et seq*. of the Commentary on Art. 11(5) of the OECD Model Convention)[129] the application of the thin capitalization rule (Art. 98) and the deemed independency of the latter (Art. 7(2) of the OECD Model Convention) would require to take into consideration, for debt-equity ratio purposes, only the loan granted to the PE and to exclude any other loan granted by Xco. to the HO (if any) not economically linked with that PE. For the same reasons it should be reasonable to calculate the debt equity ratio disregarding the equity of HO and taking into account the endowment fund of the PE (or if we agree with the interpretation stemming from the

Notes

[124] For the concept of 'loan attributable' to a PE see paras. 24 and 25 of the Commentary on Art.11 of the OECD Model Convention.

[125] However, under domestic law Italy could decide to levy a withholding tax on the gross amount without taxing the interest as PE income. See Marco Piazza, *Guida alla fiscalità internazionale* (il sole 24 ore, Milano, 2001), p. 231.

[126] Please see para. 45 of the Commentary on Art. 11 of the OECD Model Convention.

[127] Only the old Treaties of Italy-Switzerland and Italy-Ireland actually follow the reservation see Marco Piazza, *Guida alla fiscalità internazionale* (il sole 24 ore, Mialno, 2001), p. 516.

[128] Actually, due to the cherry-picking provision of Art. 169 of the Income Tax Code, whenever a taxpayer finds net basis PE taxation more favourable than gross income taxation, it is entitled to disregard the treaty and apply Italian domestic law instead.

[129] For a dissertation on when an interest is deemed to be paid by a PE rather than the HO, see John Avery Jones and Catherine Bobbett, 'Triangular treaty problems: a summary of the discussion in Seminar E at the IFA Congress in London', BIFD 1999, no. 1, pp. 16–20, at 18.

law on taxation of the net equity (*Imposta sul patrimonio netto*) mentioned above, we could also evaluate, if certain and available, the other elements of the business which could enhance its 'deemed equity').

(b) In this example, we take into account the endowment fund in order to determine the deductibility of the interest at the PE level. The calculation as required by Art. 98 will be as follows: first we check the ratio between the loan (1,000) and the endowment fund attributable to Xco for the part exceeding the ratio 1 to 4 (i.e. 30 per cent of 200 * 4 = 240),[130] then we should determine the part of the interest (100) remunerating the part of the loan exceeding the ratio 1 to 4 (i.e. 1,000–240 = 760) which is not deductible: 100/1000 * 760 = 76? interest not deductible.

3. An Italian PE borrows money from the HO

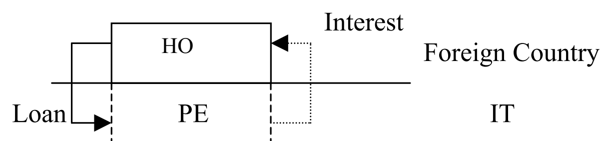

Figure 3

In this last scenario the following applies.

(a) As already pointed out by Italian tax authorities[131] a loan between a foreign HO and its PE in Italy is relevant for tax purposes.[132] Thus, if we also deem thin capitalization rules applicable to this case the following questions arise. Is there a qualified shareholder in this situation? What would be the loan and the equity value for the purposes of calculating the debt-equity ratio?

(b) It is our opinion that the HO will likely be deemed a qualified shareholder in order to apply Art. 98. Under both domestic and treaty law standpoints, the PE – despite being part of the same legal entity – is assessed on its income as a functionally separate entity so that in this respect the relationship between the HO and the PE could be compared with that of a foreign parent company holding a 100 per cent of the Italian subsidiary. As far as the loan is concerned, if we follow the route of the Italian tax authorities,[133] after the endowment fund has been put at the disposal of the PE, all the contributions in cash deriving from the HO for the benefit of the PE might be considered as interest-bearing loans. Finally, again on the basis of the arguments highlighted in this review, we deem that the PE's endowment fund could be kept into consideration in order to determine the debt-equity ratio. However, from a practical standpoint, the main issue is that often PEs are neither provided with an endowment found nor it is possible to find elements in the account ledgers that may be considered as equity (i.e. capital, reserves or profits). In these cases, there is leeway to build up a deemed equity by taking into account other elements such as debts and assets (e.g. liabilities and participations attributable to the PE). Offsetting those elements, we could end up with a result to a certain extent reliable in the lack of other feasible tools.

4. EC law issues

A first issue of thin capitalization rule compatibility with EC law has already been tackled by the Italian legislator and finally solved. As a matter of fact, a first step towards the incompatibility was made on the basis of the empowering law[134] to implement the Italian tax reform via the first draft of the legislative decree[135] approved by the government. According to that previous version the thin capitalization rule was applicable in practice only to non-residents lenders, unless subject to taxation by assessment (e.g. on PE income). The result would have been again a Member State domestic rule on thin capitalization in breach of EC Treaty freedoms; it would surely have led to the same results as the old German thin capitalization rules repealed after the suggestions and principles stated by the ECJ in the *Lankhorst Hohorst* decision.[136]

Fortunately, an amendment to the final law extended the application of the thin capitalization rule to all lenders, in order to avoid all the possible complaints in respect of the discrimination breaching Arts. 43–48 of the EC Treaty.

Based on the foregoing it is possible to say that a step forward in the goal of compatibility with the EC law of thin capitalization rules has been made so far,

Notes

130 For the first year of application (2004) the rule allows a higher ratio 1 to 5 under which the interest is fully deductible. From year 2005 the ratio will be 1 to 4. In our example we use this latter method.

131 Chapter IV, para. 4e, Ruling No. 32 of 1980.

132 Paragraph 18.3 of the OECD Commentary to Art. 7 states that – with the exception of banks (which are out of the scope of thin capitalization rules) – interest expenses arising from internal debts and receivables are generally not deductible under the Model Treaty; the OECD discussion draft on the attribution of profit to permanent establishment (para. 157) also holds that recognition of internal movements of funds as dealings is not viable for non-financial institutions, and an apportionment of the overall interest expenses should be applied instead.

133 Again, Ruling no. 32 of 1980.

134 Article 4(g) of the 80/2003 Act.

135 Article 110 of the draft legislative decree no. 344 of 2003 as published in the Ministry of Finance's website.

136 C-324/00.

nonetheless we deem that such rule still triggers some shortcomings, which need to be addressed in order to avoid any claim before the ECJ based on a EC Treaty breach.

With this in mind, we analyse below the following possible issues with the rule as it now stands:

- re-characterization of an interest payment as a dividend,
- applicability to a PE of thin capitalization rules,
- beggar-thy-neighbour Member State,
- thin capitalization and EC directives.

A. Re-characterization of an interest payment as a dividend

As already mentioned above, some scholars deem that the re-characterization of interest as a dividend does not apply to non-residents lenders (on the basis of a Ministerial interpretation).[137] Nonetheless, if one interprets literally the wording together of Arts. 23, 44 and 98 of the Income Tax Code, it is not possible to reach the same conclusion. Therefore, on the basis of the literal interpretation, should that re-characterization apply also to non-residents, then Italian domestic rules would trigger the application of a withholding tax on cross-border dividends (interest re-characterized) to non- resident lenders *provided that the Parent-Subsidiary Directive does not apply*.[138]

A clarification of tax authorities in this respect could prevent a potential issue of compatibility with the EC Treaty law currently arising for the reasons highlighted above.

B. Applicability to PE of thin capitalization rules

Another possible issue of compatibility with EC law is that of the lack of application of the thin capitalization rule to PEs. What would happen if PEs are not subject to such a rule? Taking the perspective of the home state (Italy), could a domestic law interpreted in such a way be against EC fundamental freedoms?

There does not appear to be any logical reason for treating secondary establishments of non-resident companies (i.e. PE) in a different way to local subsidiaries of foreign parent companies or resident (Italian) companies. Even if the latter different treatment (the one where the comparison is with a national company) would amount to a so-called 'reverse discrimination'[139] which is not prohibited by EC law, it is not unreasonable to argue that the former kind of discrimination, between the two forms of establishment (i.e. PE versus sub) for the foreign taxpayer, could be in breach of the right of establishment of Art. 43 of the EC Treaty. Indeed, if we deem that the thin capitalization rule is not applicable to PEs, their treatment would be more favourable as compared to that of local subsidiaries of a non-resident parent company and the question arises here whether one should consider such differential treatment as amounting to a discrimination or not.

1. Convergence and justifications

The ECJ has established the principle in its case law that the host state is required to grant to PEs of non-resident companies the same tax treatment as resident companies[140] despite the differences in both the legal form and economic treatment of PEs and subsidiaries. Therefore, if the thin capitalization rule applies only to local companies and not to PEs of foreign companies, the non-resident company exercising its right of establishment by setting up a subsidiary in Italy could claim that it had been discriminated against and consequently suffered less favourable treatment than if it had set up as a PE. Thus, an Italian thin capitalization rule as above interpreted would make it less attractive for companies established in other Member States to create or maintain a subsidiary in Italy instead of a PE. Up to now, we are not aware of any case litigated before the ECJ concerning the activity carried on through a subsidiary being treated less favourably than that carried on through a PE as a result of the thin capitalization rule. Nevertheless, the basic principles the ECJ[141] has stated in the more recent cases would suggest the need for a uniform application of the thin capitalization rule to both companies and PEs located in Italy.

As leading scholars[142] highlight, as a rule, according to a convergence principle, regardless of the perspective adopted (discrimination versus restriction and inbound versus outbound), measures without distinction, which nonetheless restrict the exercise of Treaty freedoms, are prohibited unless justified. In this respect, we do not see any reason of 'public interest' that could justify a different treatment between

Notes

137 Marco Piazza, 'La thin capitalization perdona all'estero', *Il Sole-24 ore* of 31 March 2004, p. 25.

138 According to para. 4.2 of the 16 June 2004, Circular 26/E, the Directive should apply.

139 The term 'reverse discrimination' is often used in the literature to define the effects of a domestic provision that put a foreign taxpayer in a more favourable condition as compared to a national taxpayer.

140 See among others *Compagnie de Saint-Gobain v Finanzamt Aachen-Innenstad*, C-307/97. For an overview of different treatments between PE and subsidiaries please consider Peter J. Wattel 'Corporate tax jurisdiction in the EU with respect to branches and subsidiaries ...', *EC Tax Review* 2003, no. 4, p. 194.

141 In more recent cases the ECJ has used a different language as compared to a pure non-discrimination approach. The concepts of 'hindrance', 'obstacle' 'restriction' of freedom of establishment and their use in case law show a tendency to deem rules that make it less attractive for foreign companies to exercise one of the Treaty's freedoms, as cases of infringement either. In this respect see *Lankhorst-Hohorst*, C-342-00, para. 32.

142 Ben J.M. Terra and P.J. Wattel, *European Tax law*, 3rd ed. (FED, Deventer), ch. 3.

subsidiaries and PEs as far as thin capitalization rules are concerned, neither we think that any other 'unwritten reason' (such as a loss of tax revenue or a risk of tax evasion, for the interest flowing towards a foreign country) could be easily defensible on behalf of the Italian tax authorities in an hypothetical judgment[143] to justify a worse treatment of subsidiaries.

2. *Proportionality test*

Finally, it is our opinion that the Italian thin capitalization rule, as it currently stands, runs the risk of failing the 'proportionality test'.[144] As a matter of fact, a thin capitalization rule aimed at preventing generally tax evasion of taxpayers and automatically applied over a certain threshold (a given debt-equity ratio) as the Italian one, does not keep into consideration two key elements to meet the above-mentioned test. The first element is that taxation of the interest is still possible in the country of the recipient/lender and therefore if the interest is not deductible in Italy double taxation may arise even in cases where no evasion will occur, eventually to prevent a negative effect of the indebtedness the rule would cause a worse shortcoming: double taxation; the second element is that the borrower could find in the open market a loan negotiated at an arm's length condition even when the threshold (1/4 debt-equity-ratio) is exceeded since a fixed debt equity ratio does not grant certainty of fulfilment for all market conditions.

Considering that the goals of Italian legislator with the introduction of thin capitalization rule were basically those of preventing tax evasion and avoiding excessive indebtedness of companies, the question arises here as to whether other measures would be more effective to reach the aim of preventing abuses through debt financing. Why should interest not be deductible for a borrower if the debt on which interest is paid is still in the arm's length range even if exceeding the equity ratio provided by the rule?

Maybe, the fact that the UK legislation has been recently modified could raise a further case to answer this question, since the extension of transfer pricing rules to domestic transactions has allowed the repealing of thin capitalization rules.

As far as the Italian law is concerned, instead, it is hard to believe that the current exclusion from the application of the thin cap rule – to the extent the borrower 'the debtor ... proves that the amount of loans ... is justified by its own autonomous credit standing and consequently such loans would have been granted also by third parties having as sole guarantee the corporate assets' will be sufficient to demonstrate that the proportionality test is fulfilled. It goes without saying that the possibility to show this credit capacity may prove very difficult and even more discriminatory in itself. We may think of a case where the credit capacity is linked to the ability of the borrower of the group to raise funds in the bank system. It is not difficult to imagine how hard it could be to demonstrate that credit capacity for companies of multinational group borrowing money.[145] Indeed, the result in terms of capability to find the proof might be even more difficult in relation to the different power of the banking system existing in the country where the lending company is located. Thinking to two possible scenarios, it is possible that if the lender is located in the UK, the Italian borrower (subsidiary) may more easily avail itself of the UK banking system in order to get the loan on the basis of its credit capacity while the same borrower having its lender in Italy might find it more difficult to obtain the loan with its credit capacity due to the Italian weaker banking system. With this respect a clarification by tax authorities is necessary also to understand to what extent the exception can be exploited.

C. Beggar thy neighbour Member State

The delegating Act provided that thin capitalization rules were to apply 'unless interest paid formed part of an income taxable by assessment under the [Italian] individual o corporate income taxes'; this part had already attracted much criticism by scholars[146] and – following the ECJ decision in *Lankhorst* – the final rules did not follow it.[147] This change of perspective was criticised as well, since non-discrimination could also have been achieved by extending the exempting provision to companies of other EU Member States,[148] rather than straying from the delegating Act,[149] something which the government should not be allowed to do.

Excessively harsh effects on Italian individual and

Notes

[143] For possible arguments at the basis of this reasoning please see *Lankhorst-Hohorst*, C-324/00, paras. 36 and 37 and *ICI*, C-264/96, paras. 26 and 28.

[144] According to EC law principles a 'proportionality' test would require an investigation aiming to verify whether a given measure is proportionate in its restrictive effects in relation to the legitimate aim pursued.

[145] Even if the burden of proof falls on the borrower himself on the basis of its credit capacity, it is well known that banking institutions usually keep into consideration the *de facto* guarantee of the parent company. In this same line of reasoning see also Giuliana Polacco, 'How Italy's new thin-capitalization rules work', *International tax review* 2004, no. 15, p. 22.

[146] Siegfried Mayr, 'Thin capitalization, Europa e legge delega', *Bollettino Tributario* 2003, no. 14, pp. 1049–1052.

[147] See the Assonime Circular 37 of 8 October 2003, at 6.

[148] Raffaello Lupi, 'Sull'indebitamento tradita la delega', *Il Sole-24 ore* of 16 September 2003, p. 25.

[149] Scholars have also been arguing that – to the extent it provided for discrimination and as such it was contrary to EC law – the delegating Act was rightfully not complied with and so government has been following the right course of action; see Francesco Tesauro, 'Thin capitalization a prova di delega', *Il Sole-24 ore* of 9 October 2003, p. 25.

corporate qualified shareholders were avoided by way of treating undeductible interest on excessive indebtedness as a constructive dividend in the hands of the qualified shareholder. However, this could raise more issues than it solves, as the following example makes clear.

Case study M
Company A is an Italian fully owned subsidiary of an Italian parent company, while company B is an Italian fully owned subsidiary of a foreign parent company; in all other respects, the two companies are identical, most notably in the circumstance that – if thin capitalization rules apply – each has undeductible interest expenses paid to the parent for 100. Before the Lankhorst amendment, company A would have suffered no disadvantage due to thin capitalization rules (that did not apply), while company B would have been suffering a higher corporate income tax burden for 100*33 per cent = 33. Under current thin capitalization rules, both company A and company B suffer a higher corporate income tax burden for 33, so that it looks like no discrimination is taking place any longer. However, it's quite interesting to also take into account the tax consequences on the respective parent companies; while we assume the foreign one feels no consequence of interest income being re-qualified as dividend, the Italian one does: dividends being 95 per cent exempt, interest income of 100 becoming a constructive dividend means a tax saving of 95*33 per cent = 31.45. On a consolidated basis, company B and its foreign parent company suffer higher corporate income tax burden for 33 as a result of Italian thin cap rules, while company A and its Italian parent company only suffer a higher corporate income tax burden for 33 - 31.45 = 1.65. Are we still sure no discrimination is taking place? Or is the discrimination issue simply being shifted a corporate layer up, becoming a problem of the Member State of the foreign parent company?

The problem of a subsidiary being discriminated against due to its parent's residence is thus solved, but the problem arises of the parent being resident of a state different from the one granting constructive dividend treatment.

Does this mean that the Member State of the parent will have to grant the latter the same form of economic double taxation relief it grants to parents of domestic companies in like thin capitalization situations? Does this mean that Italy shall be forced to grant constructive dividend treatment – hence, exemption – also when interest is paid from a subsidiary of another Member State, that would have qualified as a dividend if paid by a domestic subsidiary?

An affirmative answer is extremely likely when both source and residence Member States treat the interest as a constructive dividend, to the extent not deducted due to thin capitalization rules. The issue becomes even more puzzling, however, when only one of the two Member States applies constructive dividend treatment, the other simply providing for interest expenses being not deductible (or providing for no thin capitalization rule at all).

Of course, negative integration – i.e. by way of ad hoc ECJ judgments – will play an important role in this respect in future years; however, we feel that the potential coordination issues to address are too broad to be left to the ECJ only: some form of positive integration will eventually have to be made and a directive looks like the best solution, also taking into account the need for a seamless coordination with the Parent-Subsidiary Directive, which is going to be the subject of the next paragraph.

D. Thin capitalization and EC directives

In assessing the Italian thin capitalization rule compatibility with EC law a further analysis is required under EC secondary law provisions. Both the Interest and Royalties and Parent-Subsidiary Directives are relevant in this case.[150] The question arising here is whether the Parent-Subsidiary Directive applies to the constructive dividend, i.e. to the non-deductible interest as re-characterized under the Italian thin capitalization rule. A positive answer to this question would solve a double taxation issue otherwise arising due to the exclusion from the Interest and Royalties Directive of the re-characterized interest. As a matter of fact, the Interest and Royalty Directive is not mandatory where the source state (in this case Italy) under its domestic law treats interest payments as distribution of profits (Art. 4 (1)(a)), thus the source state (again, Italy) is not obliged to exempt (i.e. nil withholding tax) the interest as would otherwise be required under the scope of the Directive had it not re-characterized such interest as a dividend. It is true that in the Council's proposal[151] there was the idea of avoiding a potential double taxation by way of granting to interest as re-characterized under domestic law the application of the Parent-Subsidiary Directive, nonetheless such proposal was not reflected in the final version of the Directive[152] so that the issue of whether the Parent-Subsididary Directive must be applied still arises.

Notes

[150] Interest and Royalties Directive 2003/49/CE of 3 June 2003. Parent-Subsidiary Directive 1990/435/CE of 23 July 1990.

[151] Opinion of the Economic and Social Committee of 14 September 1998 and Art. 4(d) of Council proposal COM(1998) 67 *final* – 98/0087 (CNS).

[152] In this respect see Fabio Aramini, 'Contrasto alla sottocapitalizzazione: profili di compatibilità con il diritto comunitario e modello OCSE', *Fiscalità Internazionale* 2004, vol. 2, no. 1, pp. 71–77, at 74; Marcello Distaso and Raffaele Russo, 'The EC Interest and Royalties Directive – A Comment', *European Taxation* 2004, vol. 44, no. 4, pp. 143–154, at 150 and Paolo Troiano, 'The EU Interest and royalties directive: the Italian perspective', *Intertax* 2004, vol. 32, nos. 6/7, pp. 325–331, at 329.

With that respect we should distinguish two different perspectives: the perspective of the source state and that of the residence state. As far as the source state is concerned it is our opinion that the application of the Parent-Subsidiary Directive should be granted. We reach this conclusion on the basis of the following line of reasoning. Directives are binding upon Member States as to the result to be achieved.[153] Indeed, it is one main goal of the Parent-Subsidiary Directive that of avoiding withholding tax in the source state in order to grant neutrality on profits distributions[154] and avoid double taxation. Thus, as long as a profit distribution from an Italian subsidiary to a foreign parent company arises (including the interest distribution if re-characterized as dividend), Italy as a source Member State to which directives apply should exempt the dividend in accordance with the provisions of the Parent-Subsidiary Directive. Even if the Directive does not provide a definition of profit distribution[155] so that one might doubt whether the constructive dividend is included, we assume that dividends as re-characterized under Italian thin capitalization rule fall within the definition in order to avoid discriminations between resident recipients and foreign recipients. In other terms, since interest re-characterized under thin capitalization rule when paid to an Italian recipient is deemed as a profit distribution, that interest should keep the same nature when paid to a non-resident recipient.

On the other hand it is more difficult to argue that the Parent-Subsidiary Directive applies to the interest re-characterized by the source state whenever adopting the residence state perspective. The question in this case would be whether or to what extent the residence state would accept the qualification (re-characterization) of the interest as a dividend as provided by the source state. In these circumstances, absent any specific provision both in the Interest and Royalties and the Parent-Subsidiary Directives obliging the residence state to act in a certain way (exemption versus deduction), two possible alternatives to force the residence state application of the Parent-Subsidiary Directive would be a solution:

- at secondary EC law level, i.e. harmonizing Member State legislation with a Directive providing for a uniform pattern for the residence state behaviour and treatment of constructive dividends stemming from the source state thin capitalization rule application;
- at negative integration level, i.e. an ECJ decision on the point stating the need for the application of the Parent-Subsidiary Directive also from the residence state perspective based on the acceptance by the residence state of the source state qualification of the interest under thin capitalization rule.

In this latter case the ECJ could achieve that result on the basis of the application of the principles stated under Art. 10 of the EC Treaty read in conjunction with the tasks included in the preamble of the Parent-Subsidiary Directive.

Article 10 of the EC Treaty requires that member states should ensure the fulfilment of the obligations arising in the Treaty and resulting from actions taken by institutions of the Community and shall 'facilitate the achievement of the Community's tasks'. Certainly, the principles stated in the Parent-Subsidiary Directive (e.g. avoidance of double taxation) suggest residence state accept the qualification provided for by source state in order to facilitate the avoidance of double taxation and reach the common tasks of functioning and establishing a common market where grouping together of companies should not be hindered by tax provisions of single Member States. However, some scholars[156] pointed out that, despite any positive or negative integration and on the basis of this set of rules as it currently stands, the residence state of the income recipient should accept the source state qualification and grant Parent-Subsidiary Directive benefits at least where a DTC (between source and residence states) treats the income as dividend and in any case, where the states agree that the investment is by its true nature equity.

5. An outline of other restrictions on interest expenses

Interest non-deductibility on loans is not only a matter of thin capitalization. The Italian legislator has introduced other provisions, among the changes addressed by the Italian tax reform, affecting also interest deductions. Indeed, interest deductions on loans after 1 January 2004 are subject to four different rules in the following order of application:

- Article 3(115) of the 28 December 1995, no. 549 Act (excessive interest on debentures),
- Article 98 of the Income Tax Code (thin capitalization),
- Article 97 of the Income Tax Code (balance sheet pro rata),
- Article 96 of the Income Tax Code (income statement pro rata).

Not targeting the deductibility of interest expenses by

Notes

153 Article 249 of the EC Treaty.

154 See in this respect the preamble of Parent-Subsidiary Directive.

155 As already pointed out by some scholars as far as directives are concerned in order to interpret terms not defined therein there is not a rule such as Art. 3(2) of the OECD Model Convention. See in this respect Fabio Aramini at n. 144 above.

156 Marjaana Helminen, 'Dividend equivalent benefits and the concept of profit distribution of the EC Parent-Subsidiary Directive', *EC Tax Review* 2000, no. 3, pp. 161–171, at 168.

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the borrower, but subjecting interest income to an additional taxation in the hands of the economic payee is then the 'Prodi' levy.

A. Limitations to the deduction of interest

The first rule curtails the interest deduction on bonds issued by Italian companies provided certain thresholds are exceeded. On the deductible interest, the thin capitalization rule then applies if all the conditions above described are fulfilled. Following, interest deduction is further limited in order to neutralize the effects of the participation exemption regime whenever a loan on which the interest is paid has been granted to buy participations (assets) whose sale is non-taxable under the new exemption rule. Finally, it is worth noting that the old general provision on interest deduction[157] still applies to the extent a deductible interest survives the previous limitations. In such a case the interest remaining will be deductible on the basis of the ratio between the gross taxable revenue and earnings (as adjusted by law) and the overall amount of the enterprise's revenue and earnings.

1. Excessive interest on debentures

Most tax practitioners are aware of the thresholds for the 27 per cent WHT rate on corporate bonds coupons to turn into a milder 12.5 per cent one;[158] the interest rate (calculated as of the issue date) shall not exceed:

- twice the official discount rate,[159] for bonds negotiated on European regulated markets;
- the official discount rate plus two-thirds,[160] for all other bonds.

Something less written about is the fact that these thresholds are not only relevant for WHT purposes: they also represent the ceiling to the interest deductible by the issuer, above which no further deduction is allowed.[161] The interaction of this provision and thin capitalization is resolved in favour of the former: any interest exceeding these thresholds is not deductible, thin capitaliztion rules apply only to the deductible part (i.e. that below the thresholds).

2. Balance sheet pro rata

Article 97 of the Income Tax Code provides that whenever (as of the end of the tax period) the book value of holdings under the participation exemption regime exceeds the accounting net equity, any interest expense still deductible after the thin capitalization check (net of interest income) is non-deductible to the extent of the ratio between:

$$\frac{\text{[participation exemption holdings (book value)]}\ \textit{less}\ \text{[net equity]}}{\text{[balance sheet assets]}\ \textit{less}\ \text{[net equity]}\ \textit{less}\ \text{[trade payables]}}$$

3. Income statement pro rata

Article 96 of the Income Tax Code is a re-branding of the old Art. 63. Interest expenses still deductible after Arts. 98 and 97 are eventually subjected to the last test of all; the deductible part is that corresponding to the ratio between:

$$\frac{\text{taxable revenues and earnings}}{\text{overall revenues and earnings}}$$

However, for purposes of computing the above ratio, both sales of participation exemption holdings and (fully or partly) exempt dividends count as taxable.

B. 'Prodi' levy on guarantees

Article 7 of the 323/96 act provides that 'income from capital' arising from deposits of cash and securities[162] as a guarantee of loans granted to resident enterprises are subject to a 20 per cent levy, in addition to any other taxation such income might already suffer. The purpose of this provision is to curtail the common practice of an individual entrepreneur providing a bank with collateral in the form of mildly taxed securities, the bank then granting a loan to a company: under these circumstances, the company would deduct the interest expenses against its full CIT rate (now just 33 per cent, but as high as 53.2 per cent when the levy was devised), while the entrepreneur only was taxed at a 12.5 per cent rate.

Since foreign corporate guarantors are subject to this rule, while Italian ones are not, one could be wondering why such provision has been left standing, since it's extremely likely that the ECJ would deem it incompatible with fundamental freedoms. A possible explanation is that Italian courts are not known for making a large use of Art. 234 of the EC Treaty, so that no foreign company would risk a litigation the outcome of which could be unpredictable. However, the main reason is that Italian tax courts are quite

Notes

[157] Article 96 of the 'new' Income Tax Code includes the provision already held in Art. 63 of the 'old' Income Tax Code.

[158] Article 26(1) of the 600/73 presidential decree.

[159] The official reference rate (formerly the official discount rate) is set by the Bank of Italy, mirroring the European Central Bank discount rate; since this latter is currently 2 per cent, the relevant threshold is 4 per cent.

[160] I.e. 3.33 per cent, given the current ECB discount rate level.

[161] Article 3(115) of the 28 December 1995, no. 549 Act.

[162] Only bonds and like securities qualified for the levy, while shares and similar securities did not. For the treatment of, *inter alia*, mutual funds, insurance policies and real estate funds, reference is made respectively to Circular 269/E of 5 November 1996, resolution 100/E of 28 June 2000 and resolution 150/E of 9 July 2003.

unlikely to get involved in the matter in the first place: since litigation (although eventually successful) is always more expensive than good tax planning, availability of a simple escape route has been ensuring that the bark of the 'Prodi' levy remains far worse than its bite. A subsequent amendment[163] to the Income Tax Code provided that non resident subjects were no longer taxable on interest on current accounts:[164] since the 20 per cent levy requires that income be sourced in Italy whenever a non resident taxpayer is concerned, those amendments were like the inauguration of a four-lane new by-pass around the 'Prodi' levy.

Another loophole in this provision is that it only targets 'income from capital': to the extent 'miscellaneous income' arises, no 20 per cent levy is due (some nice planning techniques developed around this technicality). Not only, but a guarantee does not need to yield any income at all: pledging a picture by Rembrandt bears no 'income from capital' and as such is not subject to the 'Prodi' levy, while it is subject to thin capitalization rules.

The interaction of this provision and thin capitalization is resolved in favour of the latter.[165] Article 3(4) of the 344/2003 legislative decree indeed provides that the 'Prodi' levy only applies to the extent of the following ratio:

$$\frac{\text{loans granted or guaranteed not exceeding the debt/equity ratio}}{\text{all loans granted or guaranteed}}$$

6. Conclusion

Tax planners have already been reckoning with Italian thin capitalization rules in the last few months, some tax practitioners will only deal with them after it is too late (i.e. in preparing the tax return). What most Italian professionals will eventually agree upon is that – unlike previous provisions whose (maybe too ambitious) aim was not followed by an adequate implementation – the bark of Italian thin capitalization rules is not worse than their bite.

Notes

[163] Article 2 of legislative decree 259 of 21 July 1999, amending the sourcing rules under the – then – Art. 20 of the Income Tax Code (corresponding to Art. 23 of the current Income Tax Code).

[164] See para. 1.2 of the Circular 207/E of 26 October 1999.

[165] See Marco Piazza, 'Rebus sul prelievo 'Prodi' ridotto', *Il Sole-24 ore* of 13 December 2003, p. 27.

China: The Characteristics and Trend of the New Tax System Reform

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1. Introduction

The new round of tax system reform is similar to the two previous in periodicity, completeness, inherence and importance; however it differs in reform background, target, content and mode. This new reform will make the Chinese tax burden steadier, the tax structure more reasonable, tax control more perfect and tax administration more efficient and equal.

The Third Conference of the 16th Congress of the Communist Party of China has put forward the guiding theory of the tax system reform of China and the main measures necessary to perfect the socialist market economy system. This means that China will launch a new round of tax system reform. Since the reform and opening-up in 1978, China has implemented tax system reforms in 1983 and 1994. What, then, will make this tax reform different from the previous two?

2. The similarities between the new tax system reform and the previous two

A. A momentous reform every ten years

From the evolvement of our tax system reform since the reform and opening-up in 1978, a pattern of momentous tax system reform every ten years or so has emerged. In 1983 and 1984, there was a two-step switch from profit delivery to tax payment and industrial and commercial tax system reforms on the foundation of 1973's industrial and commercial tax

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