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ITALY – BREAKING NEWS FOR EU AND EEA INVESTMENT FUNDS INVESTING IN ITALIAN SHARES

The draft Budget Law for 2021 currently under review of the Italian Parliament envisages the introduction of a tax exemption on Italian source dividend and capital gains realized by EU and EEA investment funds established according to either UCITS or AIFM Directives ("**Qualifying Funds**"). If the new measures as currently proposed are approved, the favorable regime will apply to dividend distributed and capital gains realized as of 1 January 2021. However, since the new legislation is aimed at curing an existing breach of EU law, Qualifying Funds would have sound arguments to demand retrospective application of the exemption.

Background

Under current law, Qualifying Funds directly investing in Italian companies are in principle subject to a 26% withholding tax on dividend received; capital gains realized upon disposal of a qualifying shareholding (i.e. a shareholding representing more than 20% of the voting rights or more than 25% of the share capital in the participated company - if the participated company is listed, the above thresholds are reduced to 2% and 5%, respectively) would also be subject to a 26% tax under domestic law.

Such taxes apply to non-Italian funds, whereas funds established in Italy benefit from a full exemption, thus possibly representing a breach of the fundamental freedom of movement of capital under Article 63 of the TFUE, as interpreted in the EU case-law that already dealt with other Member States' tax rules relating to foreign funds (*inter alia*, C-156/17, *Ka Deka,* C-480/16, *Fidelity Funds*; C-190/12, *Emerging Markets Series of DFA Investment Trust Company*; C-347/11, *Santander;* C-303/07, *Aberdeen*).

The measures proposed in the draft Budget Law for 2021 would unconditionally remove the application of the withholding tax on dividend and capital gains in the hands of Qualifying Funds, thus removing the alleged discrimination.

Key considerations

a. ***Effectiveness of the proposed measures***

The new measures, once finally approved, should be effective with respect to dividend distributed and capital gains realized as of 1 January 2021.

However, the existing legislation is arguably in breach of Article 63 TFEU, thus remaining exposed to challenge before the ECJ. The new legislation is indeed aimed at removing such incompatibility.

b. ***Effects on indirect investments by Qualifying Funds***

Pending the approval of the Budget Law and, possibly, the issuance of public guidelines by the tax authority, it is safe to assume that the proposed provision, as drafted, is meant to benefit only direct investments made by a Qualifying Fund.

Indeed, the proposal makes reference to dividend "paid to" Qualifying Funds and, on the basis of questionable guidelines published by the tax authorities on law provisions having a similar wording, the provision should apply to direct recipients only.

At the same time, it is worth noting that, based on guidelines published by the tax authority relating to the domestic exemption on proceeds distributed by Italian real estate funds to white-listed, supervised, foreign investment funds, the exemption applies regardless of whether the foreign fund invests directly or through wholly owned intermediate vehicles).

This said, the most significant consequences of the new regime are somewhat indirect. Indeed, under

common investment structures, investment funds invest through intermediate entities established in the EU and normally eligible (at least in principle) for the application of the Parent-Subsidiary and Interest and Royalties Directives. Such directive-based benefits are more often than not challenged by the Italian tax authorities. Going forward, the consideration that the exemption on dividends and capital gains would be available in any event to the Qualifying Fund at the top of (or somewhere within) the structure, should significantly undermine the arguments for the tax authorities and tax courts to challenge the treaty- and EU-Law-based exemptions and reliefs based on the abuse of law.

More in detail, the ECJ's judgments on the application of the Parent-Subsidiary Directive (C-116/16 and C-117/16, so-called "Danish Cases") provide that the proof of an abusive practice requires, *inter alia*, the intention to obtain an advantage from the EU rules by artificially creating the conditions laid down for obtaining it.
In light of the new measures, that remove the Italian taxation on dividend distributed to a Qualifying Fund and on capital gains realized from the disposal of the shares, it would be somewhat hard to argue that the structure was artificially construed to achieve a tax (treaty- or directive-based) tax regime that the Qualifying Fund would enjoy anyway.

c. *Application of the new measures to non-EU investment funds*

In light of the wording of the proposed measures, the exemptions are meant to apply to funds established in non-EU/EEA States.

However, such exclusion would arguably continue to represent a breach of the fundamental freedom of movement of capital set out by Art. 63, TFEU, which extends to third States, irrespective of the active or passive nature of the investment (ECJ C-35/11, Test Claimants in the *FII Group Litigation*).

Conclusion and way forward

The favorable tax measures envisaged by the draft Budget Law for 2021 eliminate the main tax hurdles traditionally frustrating the direct access to the Italian market by Qualifying Funds. This will benefit both funds making portfolio investments in Italian listed shares and private equity funds. The repercussions might go well beyond the mere wording of the law. Indeed:

- in terms of geographical scope, limiting the exemption to EU/EEA funds may constitute a breach of the fundamental freedom of movement of capital (Article 63 TFEU); managers of non-EU/EEA funds should consider leveraging on EU law to defend their structures and/or engage with the Italian tax authorities to reclaim any Italian taxes on dividends and capital gains;
- similarly, by applying the exemption only as of 1 January 2021 the breach of EU law would survive for the past; fund managers should consider reclaiming any Italian taxes on dividends and capital gains suffered thus far;
- the criteria to assess whether a multi-tier investment structure may be abusively aimed at obtaining tax advantages on Italian source dividends and capital gains should change completely; again, this consideration would prove key for fund managers in defending their structure and deciding whether to initiate and/or cultivate a tax dispute.

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