TAX TREATMENT OF FOREIGN INVESTMENT FUNDS IN ITALY

On December 30, 2020, Law No. 178 ("**Law 178/20**") was published on the Italian Official Gazette introducing significant changes on taxation of non-resident investment funds.

Law 178/20 finally puts an end to the discrimination on the tax treatment of Italian-source dividends from qualified participations in Italian companies earned by foreign collective investment funds compliant with Directive 2009/65/EC or alternative investment funds managed by managers subject to supervision under Directive 2011/61/EU, incorporated in an EU Member State or in a State belonging to the European Economic Area that allows a n adequate exchange of information with Italy.

Background

Italian investment funds

Investment funds established in Italy are deemed to be resident therein for income tax purposes, regardless of their legal form, and are liable to Italian corporate income tax ("**IRES**")[1], although exempt from IRES.

The same can be said of the regional tax on productive activities ("**IRAP**") [2].

In other words, proceeds earned by Italian investment funds are generally received gross of any Italian withholding tax or substitute tax (with some minor exceptions) and are not subject to Italian income taxes.

Foreign investment funds

Foreign investment funds were subject to Italian taxes on the proceeds received from Italian companies. In particular:

- dividends were subject to 26% withholding tax; and
- capital gains earned upon sale of qualified participations [3] were subject to a 26% substitutive tax.

[1] Article 73, par. 5-quinquies, of Presidential Decree No. 917/1986.
[2] Which is generally applied at the rate of 3.9%.
[3] A participation representing more than 20% (2% in case of listed company) of the voting rights or 25% (5% in case of listed company) of the capital.

Thus, foreign investment funds used to carry out their investments through corporate vehicles (e.g. EU-based corporate sub-holdings) in order to benefit, inter alia, from the treaty exemption on capital gains and, under certain conditions, withholding tax exemption on outbound dividends under the EU Parent-Subsidiary Directive.

However, the use of such investment's structure has been extensively subject to scrutiny by the Italian tax authorities under the "beneficial ownership" test and the anti-avoidance rules, mainly relying on the lack of sufficient "economic substance".

Tax regime introduced by Law 178/20

Article 1, section 631, of Law 178/20 provides for an exemption from withholding tax on dividends paid to foreign investment funds.

The withholding exemption applies to:

- foreign collective investment funds complying with Directive No. 2009/65/EC; and
- funds that that are not compliant with the above Directive but having a manager subject to regulatory supervision in the foreign country of establishment under Directive No. 2011/61/EU.

In either case, the investment fund must be established in EU Member States or in EEA Member States which allow for an adequate exchange of information (so-called white listed Countries).

Article 1, section 633, also provides that capital gains arising from the disposal of Italian qualified participations are not subject to tax in Italy.

The abovementioned regime applies to dividends paid and capital gains earned after the date of entry into force of the law (i.e. from January 1, 2021).

Conclusions

The exemption regime introduced with Article 1 of Law 178/20 is aimed at repealing the previous discrimination between regulated investment funds established in Italy and those established abroad subject to similar regulations.

Such discrimination gave rise to numerous disputes, as it was contrary to EU legislation.

The new regime will probably have a significant impact on future investment structures. However, the new provision fails to fully address some significant concerns.

Firstly, the new exemption regime applies to dividends paid and capital gains earned after the date of entry into force of Law 178/20 (i.e. from January 1, 2021).

Therefore, some questions remain on the legitimacy of the tax burden for foreign investment funds in relation to proceeds earned prior to the entry into force of Law 178/20.

The new regime also fails to address the issue of discrimination affecting investment funds established in third countries, i.e. investment funds established outside the European Union in countries that guarantee an adequate exchange of information with Italy. Such cases could fall within the scope of application of the fundamental EU principle of the free movement of capital, meaning that any restrictions could also be invoked by investment funds established in third countries. This may be particularly relevant for investment funds established in the United Kingdom in the absence of further agreements following the withdrawal from the European Union.