Italy

The New Tax Treatment of EU/EEA Investment Funds between Solved Issues and Persistent Breaches of EU Law

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This article illustrates and critically assesses the new tax rules applicable to EU/EEA resident investment funds introduced by the Italian Budget Law for 2021 to comply with EU law obligations and incentivize foreign private equity investment in Italy.

1. Introduction

The Italian Budget Law for 2021 enacted on 30 December 2020 introduced significant changes to the rules concerning the taxation of domestic-source income received by non-resident investment funds, intending to remedy the discriminatory tax treatment that resulted from the previous regime, ultimately favouring foreign investment in Italy. After outlining the domestic legal framework that regulates the taxation of investment funds (section 2.), and the previous rules applicable to foreign funds and the legal considerations that prompted their amendment (section 3.), the author analyses the new provisions (section 4.) and finally assesses them in light of EU law, ultimately highlighting persistent traits of incompatibility (section 5.).

2. Taxation of Domestic Investment Funds

2.1. The notion of an investment fund under domestic law

Italian tax law does not provide a definition of “investment fund”, generally referring to the notion of an undertaking for collective investment (UCI) (organismo di investimento collettivo del risparmio, OICR) as defined for regulatory purposes. Under the Italian Consolidated Law on Financial Intermediation, UCIs are “bodies” providing collective investment management services, the capital of which is (i) raised from a plurality of investors; (ii) autonomously managed in the investors’ interest; and (iii) invested in securities or assets on the basis of a pre-determined investment policy. UCIs and fund managers operate under the supervision of the Bank of Italy and the National Commission for Companies and Stock Exchange (Commissione Nazionale per le Società e la Borsa, CONSOB).

The notion of UCIs is broad and comprises a variety of funds, which may be distinguished as either contractual undertakings (actual investment funds) or corporate entities (investment companies) with variable or fixed share capital. Another relevant distinction is made between open-end and close-end UCIs. Harmonized UCIs falling under the scope of Directive 2009/65/CE (EU UCITS Directive) are referred to as “undertakings for collective investment in transferable securities” (UCITS) (Organismi di Investimento Collettivo in Valori Mobiliari, OICVM). Alternative investment funds (AIF) (Fondi di Investimento Alternativi, FIA) are those UCIs covered by the provisions of Directive 2011/61/EU (EU AIFM Directive).

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2. For an overview (in English) of the main measures included in the Italian Budget Law for 2021, see G. Gallo, Italy - Italy Enacts Tax Measures to Relaunch Economy in Budget Law for 2021 (18 Jan. 2021), News IBFD.
5. For details on the different types of funds operating under Italian law, see P. Ludovici, Italy - Investment Funds & Private Equity, sec. 1.1., Country Tax Guides IBFD (accessed 20 Jan. 2021).
6. The main types of domestic funds are listed in IT: Decree of the Ministry of Economy and Finance No. 30 of 5 March 2015. For definitory purposes, see also the clarifications provided by Italian Tax Authorities (ITA) in IT: Circular 33/E of 15 July 2011.
2.2. Residence and liability to tax

All the differences outlined in the previous section[9] have in most cases no consequences from a tax point of view, except for the special set of rules applicable to funds investing in real estate property. The differential tax treatment is based on the residence of the fund instead. The Italian Income Tax Code (Testo Unico Delle Imposte sui Redditi, TUIR)[10] diverging from the triple criteria adopted for corporate entities,[11] expressly contemplates only one element to determine the (Italian) residence of investment funds, namely the law under which the fund is established, irrespective of the place of establishment of the fund manager.[12]

UCIs established under Italian law fall under the scope of the corporate income tax and are not treated as fiscally transparent entities.[13] However, despite being liable to tax, UCIs are exempt from corporate income tax and regional business tax if they (or the fund manager) are subject to regulatory surveillance (which is concretely always the case for funds established under Italian law).[14] For this reason, no tax is withheld on most of the passive income derived by domestic UCIs, including dividends paid out by resident corporations, with the exception of income from atypical securities, unlisted bonds and banker’s acceptances (in such cases the withholding tax is final).[15] The exemption of domestic funds from corporate income tax was introduced with effect from 1 July 2011[16] to achieve tax neutrality between direct and collective investment[17] in conformity with the system applicable in the majority of the other EU Member States. Based on the tax liability, the Italian tax authorities grant treaty benefits to domestic UCIs that are entitled to obtain a residence certificate.[20]

3. The Taxation of Foreign Investment Funds until 31 December 2020

3.1. The discriminatory tax treatment

The Italian system considers foreign UCIs as non-resident non-transparent entities, liable to corporate income tax.[21] Under the rules applicable until 31 December 2020, foreign UCIs were therefore subject to tax on domestic-source income. A withholding tax (at the rate of 26% starting from 1 July 2014) was levied on dividends distributed to foreign UCIs by resident corporations, potentially reduced by the provision of tax treaties when applicable. In principle, foreign UCIs should be granted tax treaty benefits like domestic UCIs (see section 2.2.). However, in practice, the preliminary issue is establishing whether the foreign fund is comparable[22] and can be regarded as a person resident in the other contracting state and beneficially owning the passive income. Nonetheless, under specific legislative provisions, UCIs falling under the scope of the EU Directives or non-harmonized UCIs subject to regulatory supervision in other EEA states should automatically be granted treaty benefits subject to reciprocity and on a pro-rata basis corresponding to the share of units held by participants resident in a jurisdiction that concluded a tax treaty with Italy.[23] Additionally, capital gains from the sale of qualifying shares in Italian companies were subject to final taxation at the same rate, except for gains on shares in stock-listed companies.[24]

On the other hand, foreign UCIs were (and still are) exempt from source taxation on investments in Italian UCIs, provided they are established in a country that exchanges information with Italy and is therefore included in the Italian “white list”. In this sense, the system in place before 2021 did not achieve tax neutrality, as direct investment was less convenient for EEA funds than investing through an Italian fund.

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9. See sec. 2.1.
11. A company is considered resident for tax purposes in Italy if its registered office (or legal seat), place of effective management or main business purpose is in Italy for the greater part of the fiscal year (see C. (Cesare) Silvani, Italy – Corporate Taxation sec. 1.1.5., Country Tax Guides IBFD (accessed 20 Jan. 2021)).
12. Art. 73(3) TUIR.
13. Art. 73(1)(c) TUIR.
14. Art. 73(5 quinquies) TUIR.
15. IT: Legislative Decree 446 of 15 December 1997, art. 3(2)(a).
16. See Silvani, supra n. 3, at p. 481.
17. See Ludovici, supra n. 5, at sec. 4.1.1.1.
18. By means of IT: Law Decree 225 of 29 December 2010. For the previous regime, see Ludovici, supra n. 5, at sec. 4.1.1.1.
21. Art. 73(1)(d) TUIR. In the lack of a domestic law definition of a foreign UCI, in practice the underlying problem is establishing whether or not a foreign fund (especially if excluded from the scope of the EU Directives) can be regarded as a UCI in as much as it is comparable to a domestic one. Such difficulties are reflected in several interpretation rulings issued by the ITA in this regard (see P. Sella, Dividendi Corrisposti a OICR Esteri: Questioni di Compatibilità Comunitaria, in Fiscaltà & Commercio Internazionale, vol. 8-9, p. 34 et seq. (2020)).
22. Id.
23. IT: Law 77 of 23 March 1983, art. 10 ter (8)(9).
24. Art. 21(1)(f) TUIR.
25. The white list is included in Decree of the Ministry of Economy and Finance of 4 September 1996, as lastly amended by Decree of the Ministry of Economy and Finance of 23 March 2017.
3.2. The EU Commission investigation and the ECJ case law

Under the tax regime in place before 2021, dividends paid to Italian UCIs were exempt from withholding tax, while dividends paid to foreign UCIs were subject to source taxation at the statutory rate, subject to a potential reduction provided for by tax treaties. Symmetrically, the previous regime exempted capital gains from the disposal of domestic qualified shareholding realized by domestic UCIs, taxing the same gains when realized by foreign UCIs.

This differential tax treatment, possibly resulting in discrimination and thereby a breach of the free movement of capital,\[26\] gave rise to doubts in terms of compatibility with EU law, which ultimately led to the reform of the tax rules at hand. The European Commission opened an investigation against Italy under the EU Pilot project with the aim of starting a dialogue to assess and fix the discrimination of non-resident funds before opening a formal infringement procedure.\[27\] The development of case law in the Court of Justice of the European Union (ECJ) on the topic is also likely to have influenced the Italian legislator. In \textit{Santander Asset Management SGIC}, \[28\] the ECJ ruled that the French legislation which, similarly to the Italian rules, exempted dividends received by domestic UCITS while taxing at source dividends received by non-resident UCITS, was incompatible with the free movement of capital. In \textit{Commission v. Belgium} \[29\] the Court reached a similar conclusion as regards Belgian legislation, which discriminated against non-resident investment companies without a permanent establishment (PE) by imposing a final withholding tax on domestic-source dividends and interest (resident investment companies and non-resident investment companies with a PE in Belgium were exempt, and could set off the withholding tax against the corporation tax payable on other items of income). The Court later found that the Polish\[30\] and Danish\[31\] rules were also in breach of EU law. Lastly, the Dutch denial of refunding dividend withholding tax imposed on non-resident investment funds did not pass the examination of the ECJ.\[32\] In all these decisions, the discriminatory tax treatment of comparable non-resident funds was found to be unjustified, either in light of the balanced allocation of taxing rights or the fiscal supervision. In addition, the prevention of tax avoidance does not justify such discrimination, at least in respect of tax treaty jurisdictions exchanging information.

4. The Taxation of Foreign Investment Funds after 1 January 2021

4.1. The new rules

The underlying incompatibility of the previous rules with EU law (see section 3.2.) finally led to their amendment. The Budget Law for 2021 sought to equalize the treatment of domestic and comparable non-resident investment funds by extending the tax exemption granted to domestic UCIs subject to conditions.\[33\]

The subjective scope of the newly introduced exemption does not cover non-resident comparable UCIs, but only: (i) non-resident UCIs established under the law of other EU Member States and EEA countries, which provides adequate exchange of information with Italy under the scope of the EU UCITS Directive; and (ii) non-resident UCIs not falling under the scope of the EU UCITS Directive, the manager of which is subject to regulatory supervision in the EU/EEA states in which the fund is set up under the provisions of the EU AIFM Directive.

Starting from 1 January 2021, dividends paid by Italian corporations to EU/EEA UCIs that meet the conditions mentioned above are exempt from taxation at source, together with capital gains (and losses) from the disposal of qualifying participations in resident companies.

4.2. Problem solved?

The amendments introduced by the Budget Law for 2021 (section 4.1.) aligned the treatment of EU/EEA UCIs falling under the EU Directives with the taxation of domestic funds, seeking to remedy potential breaches of EU law entailed by the previous rules (section 3.). Nonetheless, an accurate assessment of the new measures under the light of EU law highlights persisting traits of potential incompatibility.\[34\]
First of all, one should bear in mind that the taxation of foreign funds vis-à-vis EU law is usually a matter of the EU principle of free movement of capital, which is unilaterally granted to third countries by the EU Member States, even outside the EU framework and subject to justified and proportionate restrictions. It can be argued that limiting the scope of the exemption to EU/EEA UCIs covered by the EU Directives does not fully comply with this special feature of the freedom at stake, especially in respect of third countries that provide adequate exchange of information. In Emerging Markets Series, the ECJ dealt with discrimination against US investment funds, and found that only the lack of effective exchange of information may justify a differential tax treatment of non-EU funds. The same questions may arise as regards the treatment of EU/EEA funds that are not covered by the EU Directive yet are comparable and subject to regulatory supervision.

The second issue is the lack of retroactive application of the new rules, which solve the issue of incompatibility with EU law only for the future. The ECJ already dealt with a similar problem in relation to the Italian taxation of outbound dividends, ruling that the limitation to the retroactivity of amending provisions aimed at aligning the treatment of domestic and EU recipients of dividends was contrary to EU law.

5. Concluding Remarks

As regards the novelties introduced by the Italian Budget Law for 2021 in the taxation of EU/EEA UCIs, the exemption on dividends and capital gains granted to such investment funds after 1 January 2021 is undoubtedly to be welcomed. Not only do the new rules put an end to an underlying problem of evident incompatibility with EU law, they also achieve greater international tax neutrality, which ultimately favours foreign (private equity) investment. However, the new system preserves features that might be regarded as being in breach of the EU free movement of capital, as the new exemption, without exceptions, excludes comparable funds established in third countries that exchange information with Italy. Furthermore, the lack of retroactive effect of the new rules may also be incompatible with the ECJ consolidated case law.