UNIVERSITY OF FERRARA

# Personal Income Tax and Corporate Income Tax in Italy

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# Outline of the presentation

- How the taxation of individuals works in Italy;
- How corporate taxation works in Italy;
- What are the rules that distinguish the two types of taxation;
- Why it is important to analyze the similarities and differences between these two types of direct taxes.

# Part I
# Personal Income Tax in Italy

# Historical Evolution of the PIT

- **In the mid-1800s**, the tax system of the pre-unification states was mainly based on*:*
  - Land taxes (land was the most important form of);
  - License fees (which taxed the activities carried out on the basis of licenses, that is *authorizations*);
  - Indirect taxes (which charged wealth transfers, eg: registration tax, inheritance and stamp duty);
  - The system was based on real taxes. The landowners were the only ones to demonstrate an effective ability to pay

- **In the 1950s**, the Italian tax system was structured as follows:
  - the tax on movable wealth;
  - two complementary taxes: a progressive one on the income of natural persons and a proportional tax on the income of legal persons;
  - indirect taxes on transfers (eg: registration, inheritance, stamp duties);
  - customs duties;
  - the general income tax (IGE) which affected all supplies of goods and services;
  - the various local taxes (eg: family tax, surtaxes and surcharges).

- **1971-1973**:
  - We move from a real and proportional taxation to a personal and progressive taxation.

# The Constitutional Framework

❖ **Italian Constitution Art.2:**

"*The Republic shall recognise and protect the inviolable rights of the person, both as an individual and in the social groups where human personality is expressed. The Republic expects that the fundamental duties of political, economic and social solidarity be fulfilled*".

❖ **Italian Constitution Art.53:**

"*Every person shall contribute to public expenditure in accordance with their capability (Ability to pay principle). The tax system shall be progressive*".

# Current Personal Income Tax

**According to the Tax Base**:

❖ It is the main tax of the Italian tax system and the one that provides the most revenue;

❖ PIT was introduced only in 1971 with the enabling law n. 825/1971;

❖ Today it is regulated in the **DPR (Presidential Decree) n. 917/1986** (so-called Italian Income Tax Code)

❖ the introduction of this tax on the total income of natural persons is justified by the need to:

- personalize the levy, recognizing the relevance of the facts concerning the **personal and family situations** of the taxable person;
- implement the **progressivity** referred to in Article 53 Italian Constitution: "*Everyone is required to contribute to public expenses according to their ability to pay. The tax system is based on criteria of progression*".

❖ PIT is:

- General because it affects the taxpayer's income as a whole;
- Personal because it takes into account the economic and social situation of the taxpayer;
- Progressive because the rate increases as the tax base increases.

❖ Current Rates (Euros):

- Up to 8.000 = No Tax Area;
- Up to 15.000 = 23%;
- From 15.001 to 28.000 = 25%;
- From 28.001 to 50.000 = 35%;
- Higher than 50.001 = 43%.

# Tax Base of the PIT

- ❖ The art. 1 of the TUIR (DPR n. 917/1986) establishes that the prerequisite for the tax is «*the possession of income, in cash or in kind, falling within one of the categories established by law*».
- ❖ The constituent elements of this tax assumption are:
- possession of income;
- the circumstance that such income may take the form of cash or nature;
- belonging of the income to one of the categories identified in art. 6 TUIR.
- ❖ Possession of income:
- For tax purposes, the concept of possession, is not equivalent to the meaning of the word as under the Civil art. 1140 cc ("*Possession is the power over the thing that manifests itself in an activity corresponding to the exercise of ownership or other real right. It can be possessed directly or through another person, who has possession of the thing*") and understood as «qualified relationship with a good»;
- nor can it be understood as the material availability of income;
- has been defined in the non-technical sense as «**the qualified relationship that is established between the subject and his source of income**». The notion of possession is therefore defined by the provisions relating to each **individual category of income** (the legislator identifies possession from time to time, on the basis of the income to be taxed).

# What is Income?

- ❖ There are three notions of income:

1. **Income as a product**: new wealth created in the framework of a specific activity as defined by the law;
2. **Income as increase of wealth in a determined timeframe:** includes both the fruits of the subject's assets and activity and any increase in assets, whatever the causal origin;
3. **Income as consumption**: referring to everything that is intended for consumption (tax basis for VAT).

- ❖ The conception accepted by our system is that of <u>income as a product</u>.
- ❖ All income deriving from productive sources is taxed:

- Income produced on a continuous basis (Ex: income from work);
- Variable and eventual income (Ex: capital gain);
- «One-off» income products (e.g. winnings).
- Therefore, income can be defined as «<u>every increment of wealth generated by a productive source</u>».

- ❖ **Cash income** is to be understood as any wealth represented by circulating currency.
- ❖ **Income in kind** means any wealth that is expressed in goods and/or services, identified in art. 9 TUIR (e.g. with the so-called *fringe benefits*, i.e. with the benefits that the employer attributes to the generality or to some workers, in addition to the normal cash remuneration).

# Income Categories

- ❖ Taxable income is strictly defined in the Italian Income Tax Code (art. 6):
- **Land income→** is determined on the basis of the cadastral valuation rates (i.e. estimate of the income normally obtainable from the land or building);
- **Investment income** (interest, income, profits)→ All capital income, with the partial exception of stock dividends, are subject to substitute regimes. PIT includes only two categories of capital income: dividends from qualified participation, for 49.72% of their amount and all dividends from investments in companies resident in tax havens. **Capital income is therefore essentially taxed separately**;
- **Employment income** that includes also pensions;
- **Self-employment income**;
- **Business income→** individual entrepreneurs, partnerships. The income is attributed to each shareholder in proportion to the share of the profits, regardless of the actual perception
- Different incomes (e.g. capital gain).
- ❖ Other:
- Income obtained in replacement of income (e.g. compensation for damages from loss of profit);
- Default interests;
- Income from an illicit source (from administrative or criminal offences), if not confiscated or seized.

# Consequences

- ❖ Legal / formalistic approach to Revenue / Income for tax purposes:
- ❖ Taxable Income is only that (income) which is defined as taxable under the law;
- ❖ No Law, No Tax.

- ❖ Over formalistic approach entails two sets of consequences:
- Legal certainty: Tax is charged exclusively in cases ruled for by the law;
- In dubio contra fiscum ? (In doubtful cases the interpretation against the tax administration should be upheld)

- ❖ Leeway for aggressive tax planning:
- Possibility to circumvent the law as general anti avoidance rules (GAAR) have been introduced only recently.

# Citizenship, Residence and Taxation

- **<u>Citizenship</u>** plays no role in defining tax liability for income tax purposes;
- Complicated procedures to achieve it;
- Personal income tax in Italy is a residence-based system where income taxable is calculated according to the so called world-wide principle of income taxation;
- Few derogations because of EU Law and special attraction regimes as recently introduced.
- **<u>Residence</u>**:
- Majority of the tax period residence is to be in the state (6 months plus one day);
- Definition of residence depending on:
- **Formal criteria**: registration to the registry / Log of the individual resident in the country (link with the welfare services);
- **Substantial criteria**: Residence according to the Civil Code (Article 43); Domicile according to the Civil Code (article 43).
- **<u>Claw back provisions</u>**:
- Article 2, § 2 Income Tax Act (Act 917 passed in 1986): An Italian is deemed to be resident in the country if:
- He/she transfer his/her residence in a Tax haven as defined by the ministry of finance;
- He/she does not give evidence of the actual transfer of residence in the other state;
- ONERE PROVA-CONTRIBUENTE – Burden of proof on the taxpayer

# Dual residence and Tie Break rules

- **<u>Article 4 OECD Model</u>**:
- For the purposes of the Convention, the term “Resident of a Contracting State” means any person who, under the law of that State, is liable to taxation therein by reason of his domicile, residence, place of management or any criterion of a similar nature.

- … But this term does not include any person who is liable to tax in that Contracting State in respect only of income from sources in that State or capital situated therein.

- Tie break rules: (1) Permanent home; (2) Center of vital interests, (3) Habitual abode, (4) Nationality, (5) Mutual agreement by the two tax administration.

# The Taxpayer

- ❖ Art. 2 Italian Income Tax Code (TUIR): "*individuals, residents and non-residents of the territory of the state*"
- **residents**: all income wherever produced is taxed - the so-called *worldwide income taxation principle* (Article 3, paragraph 1, TUIR);
- **non-residents**: are taxed only for the income produced in the territory of the State. So-called *source taxation* (art. 3, paragraph 1, TUIR).
- ❖ **Criterion of connection of the person with the territory of the State:** this criterion, similarly to what is foreseen by almost all of the world's tax systems, is assumed as a qualifying element of the person's participation in the life of the State and, therefore, to the extent of his contribution to public expenses through the payment of taxes.
- ❖ **RESIDENTS** are those who, for most of the tax period meet at least one of the following three alternative criteria:
- are registered in the resident population registry;
- have their domicile in the territory of the State, understood as the center of business or interests;
- have their habitual residence (civil law residence) in the territory of the State.
- ❖ **NON-REDISENTS** (location criteria, art. 20 TUIR):
- Property income: is taxed in Italy when the property is located in Italy;
- Income from self-employment and employment: they are taxed in Italy when the work is carried out there;
- Capital income: these are taxed in Italy when the person who pays them resides in Italy;
- Business income: they are taxed in Italy when the permanent organization of the company is located in the territory.

# Employment Income

- ❖ Employment gross taxable income includes all compensation (cash or benefits in kind) received by the employee in relation to their employment relationship, including: bonuses, stock options, interest free loans, overseas adjustments, cost of living allowance, tax reimbursements, car allowance, etc.

- ❖ As a general rule, 100% of compensation paid in cash is subject to tax (exceptions apply), and compensation paid as fringe benefits (such as housing, loans, company car granted for personal and business use) are taxed on the base of the 'normal value' or on a lump-sum basis.
- Normal value is defined in Article 9 of the Italian Tax Act, as the price generally applied to similar goods and services on the market.
- In particular, for shares, bonds, and other securities listed on stock exchange or traded over-the-counter, the normal value shall be determined on the basis of the average closing price during the preceding month.

# Business Income

- Business income arises from the performance of commercial activities and is subject to corporate income tax. Unless the case is for a solo entrepreneur or partnerships;

- Generally, it is calculated on an accrual basis as the difference between proceeds and expenses relating to the commercial activity.
- Business income is also subject to IRAP (Regional tax on productivity).

- Non-resident individuals are required to declare only Italian source business income. Income derived by a foreign entity from a business carried on through a PE in Italy is assumed to be Italian source.

# Real Estate Income

- Since Fiscal year 2013, a principal abode is no longer subject to Immovable Property Tax and is subject to PIT, and has to be reported in the tax return.
- **Principal abode**
- The taxable income deriving from the ownership of a principal abode is calculated on the basis of its adjusted 'cadastral value', which corresponds to the 'ordinary'/'average' income deemed to be derived from such properties, determined by the Cadastral Office in consideration of their characteristics.
- The taxable value for principal abode can be deducted by the gross taxable income.
- **Real estate at disposal**

- Immovable Property Tax has substituted PIT for real estate at disposal, but it has to be reported on a tax return in any case, and no taxable income arises. An exception is provided for real estate at disposal located in the same municipality in which is located the principal abode, which constitutes taxable income in the measure of 50% of the adjusted cadastral value.

- **Real estate rented**

- Taxed at a progressive tax rate.
- In case of rented real estate located in Italy, the taxable income generally corresponds to the highest amount between:

1. The cadastral income increased by 5% and 95% of the rentals referring to the relevant tax period (even if not actually collected, with some exceptions).
2. For leased buildings, the law admits a 5% flat rate reduction of rentals in consideration of eventual managing and maintenance expenses incurred by the owner.

- As a result, related expenses actually incurred are not relevant for tax purposes.
- The taxable income, as determined above, is subject to a progressive tax rate.

# Special regimes

- ❖ **Tax at a flat tax rate**
- ❖ As of Fiscal year 2011, a new tax regime, called in Italian cedolare secca (Tax at Source), has been introduced.
- ❖ It is a voluntary and optional tax regime in respect to the ordinary one. In this case, the rental income can be taxed at a fixed tax rate equal to 21% or 10%, provided some conditions are met.

- ❖ This taxation replaces:
- The incomes tax (national, regional, and municipal);
- The registration tax;
- The stamp duty, and Other taxes.

- ❖ The taxable income is 100% of the rental income.

# Investment Income

❖ Investment income is generally defined as income arising from the use of capital, typically interest and dividends.

❖ **Shareholdings**

- The dividends distributed by a foreign entity that are not paid through an Italian resident broker shall be included (gross of foreign taxes withheld) in the individual's tax return and taxed at a 26% flat rate.
- In this case, no foreign tax credit can be claimed.
- Dividends distributed by a foreign entity and paid through an Italian resident broker are subject to tax at a 26% flat rate (net of foreign taxes withheld). In this case, no further action will be required.

❖ **Interest income**

- Interests are subject to a flat tax rate of 26% to be applied at source;
- For specific interests stated by the tax law (e.g. government bonds and other bonds issued by public entities mentioned in Article 31 of D.P.R. 29 September 1973, no. 601 and similar financial instruments), the tax rate remains at 12.5%.

# Capital Gains

- Capital Gain is the difference, only if it is positive, between the sale/repayment price of a financial instrument (shares, warrants, convertible bonds, options, option transactions, etc.) and its purchase/subscription price. There is therefore a Capital Gain when the share is sold at a higher price than the purchase price. This measure constitutes only a part of the total return of an investment since it does not consider the possible receipt of periodic results (dividends). For individuals, capital gains are generally taxable, even if they do not arise from speculative intent or from a business.

- **Qualified shareholdings**

- The capital gains earned by the sale of qualified shareholdings is taxed as follows:

a) Capital gains made before 31 December 2017: 49.72% of capital gains is included in the individual annual gross income (income taxed applying progressive tax rates);

b) Capital gains made between 1 January 2018 and 31 December 2018: 58.14% of capital gains is included in the individual annual gross (income taxed applying progressive tax rates);

c) Capital gains made as of January 2019 will be taxed applying a flat tax rate of 26% on the whole capital gains amount. The 2018 Italian Financial Bill introduced a final WHT at 26% both to tax resident and non-tax resident individuals for capital gains deriving from a qualified and a non-qualified shareholding (starting from 1 January 2019).

- **Non-qualified shareholdings**

- The capital gains earned by the sale of non-qualified shareholdings is taxed applying a flat tax rate of 26%.

# Capital gains tax on the sale of a real estate

❖ The taxable base of the real estate capital gains is the difference between the sale price and the original cost of real estate together with the sum of all the additional purchase costs (notary fees, taxes, etc.).

❖ The capital gain on the sale of real estate is taxed at progressive tax rates or with a substitutive flat tax of 26% under certain conditions.

❖ There are some exemptions, however, and such are applicable on capital gains deriving from the following sales:

- The sale of a real estate if owned for more than five years.
- The sale of a real estate, even if owned for less than five years, if it has been used as primary residence for most of the period of ownership (even if owned for less than five years).

# Particular Cases

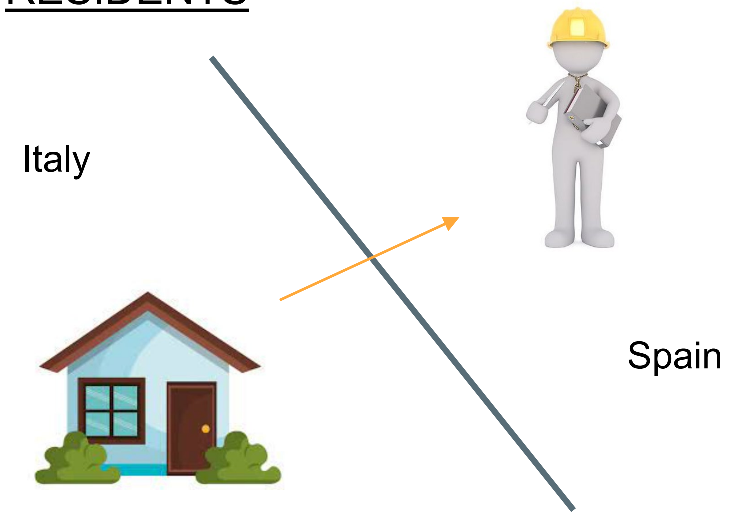
1. **Self-employment workers:**

- Have the VAT number;
- For the first 5 years they pay 5% of the income → income must be less than 85.000 Euros;
- After 5 years, they pay a flat tax of 15% → income must be less than 85.000 Euros;
- If the Income is over 85.000 → they pay PIT with ordinary and progressive rates;
- The difference between an employee and the self employee → the first is NOT called to pay VAT on his income; but the self employee (in ordinary regime) must pay also the VAT such us a company. So he will pay PIT and also VAT;
- Income from self-employment could also be subject to IRAP (Regional tax on productivity).
- Professionals are required to keep accounting records, but directors and statutory auditors do not have to keep such records.
- Non-residents who are self-employed are subject to a 30% final withholding tax (WHT) unless otherwise provided by DTCs: in this case, they are not required to file an income tax return.

2. **Dividends and similar income; interest and other income deriving from current accounts and bank and postal deposits, bonds, similar securities and financial bills** → flat tax 26%.
3. **Partnerships** (such as lawyers) → generate income from self-employment and not from business. They are equivalent to simple companies taxed for transparency.

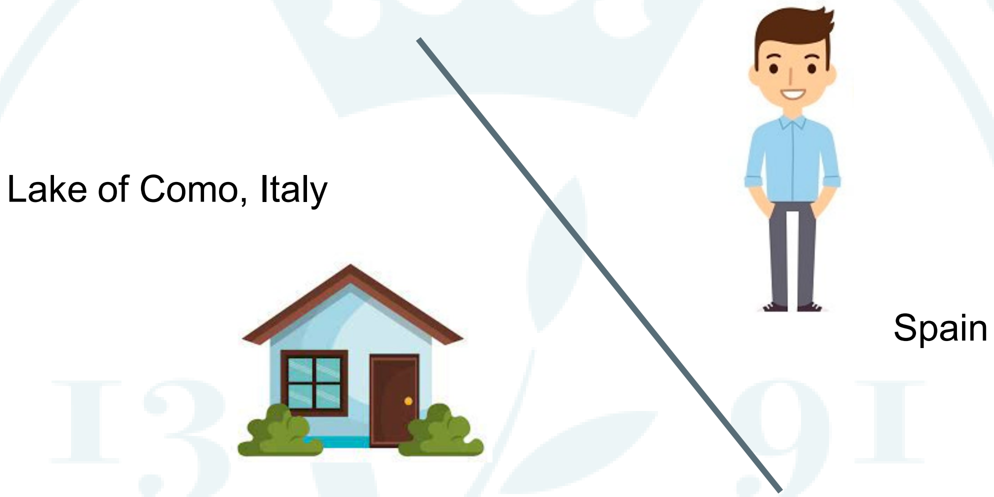
# Examples and problems

RESIDENTS




- The Employee will be taxed in Italy where he has his residence;
- He could also be taxed in Spain where he works.
- Problem: double taxation.
- Solution: conventions to avoid double taxation or Tax Credit.

NON-RESIDENTS




- The taxpayer will be taxed in Spain for his income;
- He could also be taxed in Italy, ‘cause he own a (beautiful) house in Lake of Como.
- Problem: double taxation.
- Solution: conventions to avoid double taxation or Tax Credit.

# Total Income

**<u>Art. 8 TUIR</u>**

"*The total income is determined by adding the incomes of each category that contribute to forming it and subtracting the losses deriving from the exercise of commercial enterprises pursuant to art. 66 and those deriving from the exercise of arts and professions*".

The **total gross income** is given by an algebraic sum.

Sum of all income of the individual categories and subtraction of the losses incurred.

The losses of simple partnerships and professional associations (taxed for transparency) are charged pro rata and for transparency to the partners and associates;

The losses deriving from the exercise of commercial enterprises and from the participation in snc and sas, are calculated as a reduction from the relative incomes achieved in the tax periods.

# Tax deduction and tax detraction

IRPEF is a personal tax since it takes into account not only income, but also other elements of a personal nature:

- Deductions;
- Detractions.

Deductions favor higher incomes, because the taxpayer's advantage increases as the marginal rate increases; Deductible expenses are personal expenses that affect the taxpayer's ability to pay.

**What are the deductible expenses?**

- Medical expenses for serious disabilities;
- Periodic checks paid to the spouse following separation;
- Social security and welfare contributions paid pursuant to the law;
- Contributions paid to supplementary pension schemes;
- Some donations
- Land charges not taken into consideration in the cadastral estimates;
- Sums given to employees who hold electoral offices;
- Compensation for loss of goodwill (from landlord to tenant);
- Amounts that the taxpayer must repay and which have already contributed to the formation of income in a previous tax period.

**Detraction that are subtracted from the gross tax**:

- For dependents of family (art. 12, TUIR) attributed to those who have families (now there is the single family allowance);
- For employees (art. 13, TUIR) which replace the deduction of production costs;
- For charges (art. 15, TUIR):

i. To the extent of 19% of some expenses;
ii. (Interest expense on mortgages, health care expenses, funeral expenses, education expenses, life insurance premiums, etc ...)

# Example

**Luigi**

**Income**

- Employment Income → 45.000 Euros;
- He is a partner (with a friend) in a partnership that generates profits of 40.000 euros per year → 50% of profits: 20.000 Euros.
- Luigi's total income (for year) is 65.000.

**Deduction**

- Luigi is separated from his wife and pays her a monthly check→ 1.000 Euros / month;

**Detraction**

- Luigi renovated his house with an expenditure of 50.000 euros → in Italy this kind of expenses are detractible for 50%: 25.000.

**How much he has to pay for income earned in 2022?**

- 23% up to 15.000 Euros → 3.450;
- 25% applied to the difference of 28.000 – 15.001 → 3250;
- 35% applied to the difference of 50.000 – 28.000 → 7.700;
- 43% up to 50.000 → in this case applied to the difference of 65.000-50.000 → 6.450.
- TOTAL IRPEF (without deduction and detraction) → sum of 3.450+3250+7.700+6.450 = 20.850 Euros.

**Deduction**:

- 1.000 x 12 = 12.000 Euros.
- TOTAL INCOME → 65.000 – 12.000 = 53.000.
- TOTAL IRPEF → 15.690 Euros.

**Detraction:**

- Total Irpef – detractible expenses → 15.690 – 25.000 = - 9.310.
- Luigi has a belief towards the Treasury: he can ask for a refund or offset it the following year.

# To recap..

a) Identification and determination of individual incomes, according to the rules specific to each category;
b) Calculation of total income, by means of the algebraic sum of income and losses for the period (and subtraction of losses from previous periods);
c) Calculation of taxable income by deducting charges from total income;
d) Once the tax base has been determined, the tax rates are applied to it;
e) The following are deducted from the net tax (art. 22, paragraph 1, TUIR):

- Tax credits;
- Tax credits paid abroad;
- Tax credit for hiring workers;
- Advance payments;

f) Withholding taxes incurred

DEBIT BALANCE: The net tax is greater than the credits and advances. OBLIGATION TO PAY BEFORE RETURNING CREDIT BALANCE.

The net tax is less than credits and advances THE TAXPAYER HAS A CREDIT

# The Enduring Paradox

- Income to be taxed on a personal basis:
- All income owned by an individual;
- No matter the source of it;
- Progressive taxation;
- Lot of income taxed with a flat tax and with substitutive tax;
- Progressivity of the system has been eroded through years via an array of special, tailor made rules;
- Constant tension between constitutional principles and the law;
- Necessity to regulate PIT consistently with the EU fundamental
- principles;
- Duty of reporting automatized.

Yet …

Progressive expansions of taxation at source;

Carve out from the taxable base of selected items;

**Conclusion**: a system based on rules and derogations.

# Part II
# Personal Income Tax and Corporate Income Tax: analogies and differences

# Historical evolution of the Corporate Income Tax

- 1954: Corporate tax;
- 1974: corporate tax replaced by IRPEG (Corporate Income Tax) which remained in force until 2003;
- 1 January 2004: introduction of IRES (Corporate Income Tax) to replace the IRPEG, with Legislative Decree 12.12.2003 n. 344, GU 16.12.2003;
- Proportional and personal Company Income Tax at a rate of 27.50% until 2016, since 2017, following the 2016 Stability Law, there has been a lowering of the rate to 24%.

- The related discipline is contained in Title II of the Decree of the President of the Republic 22 December 1986, n. 917 of the TUIR.
- Prerequisite for the tax: possession of income in cash or in kind falling within the categories indicated in art. 6 of the TUIR.

# Characteristics IRES

- IRES is a direct tax;
- It is a real tax because it is unthinkable that the tax can be linked to the personal and family situation of the subject (this is the most important difference between IRES and IRPEF);
- It is basically a general tax, in fact it affects the total income;
- IRES is also a fundamental tax, because the legislator expects a high revenue from IRES;
- It is a proportional tax of 24%.
- Why is the rate important? Because big capital is managed by companies. Large enterprises are run in the form of corporations. Then companies can move the places of production of the goods according to the EU area where the levy is lower and this precisely because there are no restrictions on the movement of goods within the EU.

# The Taxpayers

❖ Art. 73, co. 1 and divided into 4 sets:

1. joint stock companies, cooperative companies and mutual insurance companies resident in the territory of the State (Article 73, paragraph 1, letter a);
2. public and private entities other than companies, as well as trusts, residing in the territory of the State, which have as their exclusive or principal purpose the exercise of commercial activities (Article 73, paragraph 1, letter b);
3. public and private entities other than companies, as well as trusts, residing in the territory of the State, which do not have the exercise of commercial activities as their exclusive or principal object (Article 73, paragraph 1, letter c);
4. companies and entities of all kinds, including trusts, with or without legal personality, not resident in the territory of the State (Article 73, paragraph 1, letter d).
5. Pursuant to art. 74, paragraph 1, TUIR, **are not subject to IRES** «the bodies and administrations of the State, including those with autonomous systems, even if endowed with legal personality, municipalities, consortia between local authorities, associations and management bodies of collective state property, the mountain communities, the provinces and the regions [...]»

# Criteria for identifying taxable companies

- **Criterion of Commerciality:**
- This criterion, to be considered exclusive and main, must be carried out for the achievement of the purposes of the institution, with reference to: - object determined on the basis of the law, the deed of incorporation or the statute; - activity actually carried out in the territory of the State.
- **Residency Criterion:**
- a company or entity is considered resident which, for most of the tax period (183 days for periods of one year), has in Italy, alternatively: • the registered office • the administrative office • the main object of the activity.
- of **the art. 73**, the co. 5-bis: «Unless proven otherwise, the headquarters of the administration of companies and entities which hold controlling interests pursuant to art. 2359, first paragraph, of the civil code in joint-stock companies or commercial entities, if, alternatively:
- ✓ they are controlled, even indirectly pursuant to art. 2359 of the civil code, by persons residing in the territory of the State;
- ✓ are administered by a board of directors (or other equivalent body) composed mainly of directors residing in the territory of the State» (Relative presumption of residence).

# The case of *Foreign Dressed Companies*

**Fictitious localization abroad** of a company's fiscal residence

**Art. 73 TUIR**: For the purposes of income tax, companies and entities are considered to be resident if they have their

### ***Registered Office***

- The place where the **management and administrative center of the company operates.**
- Where legal acts are carried out on its behalf, with the usual presence of the directors with power of representation.

### ***Corporate Purpose***

- The **essential activity** to directly achieve the primary purposes indicated by law, memorandum of association or articles of association.
- In the absence, "***the activity actually carried out***".

### ***Administrative Headquarters***

Place **designated or permanently used for the centralisation** - in internal and third-party relations - of the company's bodies and offices in order to **carry out the company's business and drive its activities.**

***..in the territory of the State for most of the tax period***

# Example

**ITALY**

**IRAN**

Place **designated or permanently used for the centralisation** - in internal and third-party relations - of the company's bodies and offices in order to **carry out the company's business and drive its activities.**

**The company have to pay taxes in Italy also if it has its residence in Iran.**

# Aim of the FDC

**Fictitious localization abroad** of a company's fiscal residence

**Benefits from a more advantageous tax regime**

- Avoid the most **onerous national regime**
- **Profits** are subject to lower taxation
- **Capital Gains** from the **sale of Shareholdings** are subject to lower taxation
- Reduce **indirect** Italian taxation on the conferral


The location of the subjective dimension is based on falsity and cannot be brought within the ambit of *tax avoidance*, but represent **cases of evasion**.

# Penalties for FDC

**Relative legal presumption**:

a. Demonstration of having maintained the **seat of administration abroad**;
b. Registered office of the management of companies, which **hold controlling stakes**, are **controlled**, including indirectly;
c. **Administered** by a board of directors, or other equivalent management body.

If the foreign legal entity **fail to provide** the relevant evidence to the contrary, the same

- Considered **resident** in the territory of the State;
- Subject to all the **obligations** provides for companies and entities resident in Italy.

**Administrative level:**

- Omitted establishment of obligatory **accounting records for VAT and income tax purposes**;
- Omitted request for assignment of the tax code number;
- Omitted presentation of the declaration of commencement of activity and of the place of **keeping and conservation** of books, registers, writings and mandatory documents;
- Omitted presentation of the annual income declaration for **IRES-VAT-IRAP** purposes;
- **failure to submit a tax declaration.**

**Criminal level:**

- Omitted declaration punishes with imprisonment from 2 to 6 years when the **evaded tax exceeds 50.000 Euros**.

# Two Cases

**<u>Supreme Court, Section III, 17/01/14 n. 1811</u>**

Preventive seizure of a current account of a **Maltese company** operating in Italy, from Malta, throught a server.

1. **Excluded the existence of a stable organization in Italy**, because this does not have there a seat of direction, nor a branch being the game server, necessary to carry out the activity of the company, located abroad.
2. **Excluded headquarters in Italy**, because there would be carried out only the activity of online assistance to customers and not also the more complex activity of management of the computer platform necessary for the exercise of online games.

<u>Convention to avoid Double Taxation (OECD)</u>

«*Dual Residence*» phenomena and avoid double taxation**, art. 4 of the Convention** establishes that the legal entity must be considered resident ("only" in the English version) in the State in which the place of **effective management** of the entity **is located**.

**<u>Supreme Court, 15/03/2022 n. 8297</u>**

A company based in Luxembourg and the holding company for the group, has been served notice of an assessment for 2005 for IRES and VAT purposes. The tax notice was issued following an audit carried out by the tax police, which revealed that the company, which is formally based in Luxembourg, is in fact resident in Italy.

1. It is necessary to verify that the **essential purpose of the operation** is limited to obtaining the tax advantage, as it is not sufficient to apply a general predetermined criterion.
2. Referral to EU Court of Justice on the subject **<u>of freedom of establishment</u>**, a company set up in a member State in order to benefit from more advantageous tax regulations does not in itself constitute an abuse of this freedom.

Restriction on the freedom of establishment can only concern «**wholly artificial arrangements**, devoid of economic effectiveness and aimed at circumventing the normal taxation of profits generated by activities carried on in national territory».

# Commercial Entities

- ❖ They are considered commercial entities (art. 73, co. 1, lett.b) and co. 2):
- public entities, other than state bodies and administrations;
- private entities that carry out commercial activities exclusively, or mainly with respect to other activities;
- resident trusts;
- UCITS (Collective Investment Organizations) resident in Italy (new from 2012).

Public and private entities include both those with legal personality and those without it, provided they have a unitary and autonomous organization.

- ❖ The exercise of commercial enterprises is understood to be the habitual, though not exclusive, exercise of the activities indicated in art. 2195 of the civil code as well as the exercise of activities aimed at the provision of services which, although not attributable to those indicated by art. 2195 of the civil code are - organized as a business; - economic (payments suitable for remunerating the production factors used).
- ❖ Art. 2195 c.c.: "*An industrial activity aimed at the production of goods or services; 2) an intermediary activity in the circulation of goods; 3) a transport activity by land, water or air; 4) a banking or insurance business; 5) other auxiliary activities of the previous ones*".

# Limited Liability companies

- The subjects referred to in lett. a) of the art. 73 TUIR are:
  - joint companies and limited partnerships;
  - limited liability companies;
  - cooperative societies and mutual insurance societies;
  - European companies referred to in Regulation (EC) no. 2157/2001;
  - European cooperative societies referred to in Regulation (EC) no. 1435/2003 resident in the territory of the State.
- They are companies defined as such because in them the capital element has a conceptual and regulatory prevalence with respect to the subjective element represented by the shareholders.
- The shareholding of the shareholders in the share capital can be represented by shares or quotas according to the specific corporate typology.

# Derivation principle

❖ **Derivation principle**

Art. 83 TUIR: "*Total income is determined by adding to the profit or loss resulting from the income statement, relating to the financial year ended in the tax period, the increases and decreases resulting from the application of the criteria established in the subsequent provisions of this section*". Principle of derivation The income (or loss) to be indicated in the declaration therefore does not coincide perfectly with the profit (or loss) emerging from the financial statements.

The starting point for calculating the tax income is the result (profit or loss) achieved by the company according to the calculation criteria of the civil code, to which specific variations are then made in accordance with the tax regulations.

❖ **Increasing variations:**

They increase the taxable amount.

• Costs and charges that are not deductible, in whole or in part;

• Costs and charges whose deduction is deferred to subsequent periods;

• Income not charged to the income statement but fiscally relevant.

<u>Examples</u>:

• IMU related to the property assets is non-deductible;

• Motor vehicles: the deductibility of depreciation is limited in percentage and within a maximum threshold;

• Losses on credits not resulting from certain and precise elements.

❖ **Decreasing variations:**

They reduce the taxable amount.

• Deductible costs even if not charged to the income statement;

• Costs and charges whose deduction has been deferred from previous periods;

• Income that is not taxable or whose taxation has been deferred to subsequent periods.

<u>Examples:</u>

• Directors' fees: these are accounted for on an accrual basis in the financial statements but are deductible in cash. Increase when accounted for and decrease when paid (art. 95, co. 5 Tuir);

• Dividends: They are taxable at a rate of 5% (art. 89 Tuir).

# All-in principle

FORCE OF ATTRACTION with respect to other categories of income: any income earned in the context of business activity constitutes business income, regardless of the income category to which it belongs.

**Examples:**

- as a consequence of the all-inclusive principle, and as an exception to the general principles, the sums received as donations also constitute taxable income for the company;
- If a company has a commercial income of 100.000 Euros and the same company received each month 1.000 Euros for the rental of a property, the whole income is 112.000 Euros.

# Principle of inherence

- The cost incurred as part of the business activity is inherent.
- There must be a functional link between the cost and the life of the business.
- In the doctrine there are those who believe that the legal basis of the principle of inherence is Article 109, co . 5th of the Tuir; others instead believe that it is a pre-juridical concept (so that an income could only be calculated net of the costs incurred to produce it).
- The principle of inherence allows the deductibility of costs only to the extent that they relate to the business activity carried out.
- It is believed that it is not necessary that the cost incurred has generated revenue, but it is deemed necessary that the same has generated a benefit, even potential, mediated or indirect for the company.

# Examples

❖ The following are **inherent**, and therefore **deductible**:

• costs for the purchase of raw materials, or for work performance;

• costs for studies and research, for the development of a brand, or for advertising.

❖ The following are **not inherent**, and therefore **non-deductible**:

• Costs incurred for the benefit of the entrepreneur and not for the company (costs for a holiday);

• Donations (except those provided for by law);

• Charges for penalties;

• Costs incurred for the benefit of group companies in the absence of an advantage for the company that bore the cost; these costs must be charged back.

❖ **Special cases**: the same cost may be inherent, or non-inherent, depending on the company's activity.

The cost for a designer painting:

• is not deductible for a metalworking company, but

• can be deductible for a luxury hotel

# Accrual principle

❖ Business activity is a continuum. However, there is a need to determine the result relating to a **specific period**, conventionally identified in the financial year.

❖ The temporal allocation of the income components relevant for tax purposes is based, except for exceptions provided for by law, on the so-called accrual period.

❖ It assumes importance the moment in which the managerial event from which the income component derives occurs (economic accrual) Costs/revenues time correlation.

❖ The rules on temporal allocation of the income components are mandatory for both taxpayers and the tax authorities. A distinction must be made between:

- **Sales of goods** (records the delivery, or transfer of ownership for buildings);
- **Provision of services** (records the completion of the service or, if periodic, the accrual of the considerations).

❖ Some income components are relevant on a cash basis, rather than on an accrual basis, based on legal provisions (e.g. Dividends, directors' fees…).

❖ In order to be relevant, an income component must be legally certain in its existence (an), by the end of the tax period If the requirement of certainty is missing, the tax relevance must be deferred In addition to being certain, it must also be determined in its amount (quantum), that is, objectively determinable (it must be possible to quantify on the basis of certain criteria).

# Depreciation rule

- ❖ The definition of capital goods includes all those tangible and intangible assets (eg equipment, plants, trademarks, patents) that businesses and professionals use to carry out their business. These are goods that are used for several years. For this reason, their accounting entry is made following the **depreciation principle**.
- ❖ The depreciation of the cost of capital goods consists in "spreading" the purchase cost of the asset over several years.
- ❖ This means that whoever buys capital goods does not immediately deduct the entire cost incurred but only the portion relating to the year of use.

**Example:** if you purchase a plant worth €10,000.00, it will not be possible to deduct the entire amount in the first year but you will have to divide it by the duration of the depreciation (usually 5 years). Consequently, € 2,000.00 can be deducted for each year of use.

- ❖ On the other hand, assets that do not have a long-term usefulness (non-instrumental) and assets that are only used and not purchased by the company or professional (eg leased, hired or rented assets) cannot be depreciated.
- ❖ The duration of depreciation depends on the duration of use of the asset.
- ❖ This principle applies above all for the purposes of preparing the financial statements (statutory depreciation).
- ❖ Tax legislation, on the other hand, provides for standard depreciation periods which depend on the company's business sector and the type of asset purchased (depreciation coefficients).
- ❖ Only for assets with a value of less than €516.46 is it possible to deduct the entire cost of the asset in the year of purchase (super-depreciation).

# Example

| **Machine X is bought for €8,000 and is assumed to last for 4 years** | **Value of the asset** |
|---|---|
| Period 1 the asset is new: it is worth €8,000 | At the end of the period, the used asset has lost €2,000 in value |
| Period 2 the asset is used: it is worth €6,000 | At the end of the period, the used asset has lost €2,000 in value |
| Period 3 the asset is heavily used, it is worth €4,000 | At the end of the period, the used asset has lost €2,000 in value |
| Period 4 the asset is heavily used, it is worth €2,000 | At the end of the period, the used asset has lost €2,000 in value |
| Period 5 the asset is old, it is no longer worth anything | The asset is no longer worth anything, it could be thrown away |

# Depreciation of tangible assets

❖ The depreciation quotas of capital goods are deductible starting from the year in which the asset enters service, or from delivery in the case of leasing.

❖ Ordinary depreciation is calculated by applying the coefficients established for the various categories of goods and activities (DM 31 /12/1988), reduced by half for the first financial year

❖ The measure given by the coefficients is the maximum deductible, but depreciation to a lesser extent is permitted.

❖ For depreciation of buildings, the value of the area must be separated In case of elimination of the asset from the production process, the unamortized residual cost is deductible.

**Examples**:

- motor vehicles, commercial and industrial vehicles (e.g. vans, trucks) as well as all the equipment and systems of a manufacturing company as well as office machines and furnishings (e.g. computers, smartphones, desks, wardrobes). The tax depreciation of these assets takes place over a few years (as a rule, within the first **10 years of use**).
- Another category of capital goods is that of real estate (operating buildings). This category includes sheds, warehouses, offices and shops. These can be both existing properties and properties to be built. For this category of assets, the depreciation period is generally very long (in some cases up to **50 years**).

# Depreciation of non-tangible assets

- Trademarks, patents, rights to use intellectual property such as software and other intellectual property rights. For these assets, the duration of depreciation depends on the speed with which the asset loses value (e.g. the obsolescence of a software) or on the duration of the right (e.g. duration of the licence, duration of the patent).
- Rights to use intellectual property, industrial patents, processes, formulas and information relating to experience acquired in the
- industrial, commercial or scientific field. The amortization quotas are deductible up to 50% of the cost;
- Goodwill: The quotas are deductible up to a maximum of one eighteenth;
- Trademarks: The quotas are deductible up to a maximum of one eighteenth;
- Concession rights and other rights recorded in the balance sheet. The quotas are deductible on the basis of the duration;
- Other long-term charges. They are deductible up to the amount attributable to each financial year (art. 108).

# Non-commercial entities

- ❖ Resident non-commercial entities are "public or private entities, other than companies, as well as trusts, which do not have as their exclusive or principal object the exercise of commercial activities, residing in the territory of the State" (Article 73, paragraph 1, letter c)). In order for an entity to be considered non-commercial, it is necessary to identify the essential activity carried out to achieve its goals by referring to:
- object determined on the basis of the law, statute or deed of incorporation;
- activity actually carried out in the territory of the State (art. 73, paragraph 4).
- ❖ Non-commercial entities may have business income from secondary commercial activity.
- ❖ Non-commercial entities can carry out both institutional and commercial activities:
- Institutional activity: (e.g. cultural, social, welfare) always present;
- Commercial activity: possible (therefore non-exclusive and prevalent) and aimed at raising funds.
- The TUIR then identifies further "decommercialized" activities in Articles 143 and 148, the latter valid with specific reference to associations, and which do not give rise to business income.

# Income for Non-commercial entities

- The total income is given by the sum of the various incomes produced (art. 143 TUIR);
- Situation completely analogous to that of natural persons (cf. art. 146 and 147 TUIR);
- **Remember well**: only commercial entities produce business income.

Their total income is made up of various categories of income: **Land; of capital; Of enterprise; Different** without the place of production of the income, nor the destination of the same, being of any importance.

To determine the overall income of non-commercial entities, the taxable income indicated above must be added, deducting the losses deriving from the exercise of trades and professions.

# Example

Commercial

Land and farm let
to a farmer who cultivates it

10% sghares of a
profitable company

NON
Commercial

Land and farm let
to a farmer who cultivates it

10% sghares of a
profitable company

IDENTICAL SOURCES OF INCOME

# Continued

**<u>Common assumption</u>**:

- Land has a cadastral income attributed to the owner of euro 2.000, but the rental fee to be paid to the owner is of euro 5.000.
- Shares generate dividends for euro 1000

**<u>Commercial entity (company) tax base</u>**

- Rent form land is **business income** for an amount of 5.000;
- Dividends is business income for an amount of 50 (tax law provides for an exemption of 95% for commercial entities);
- Total Income: 5.050 Euro x 24%.
- Total Income Tax: 5.050 Euro x 24% = **1.212 Euro**.

**<u>Non commercial entity tax base</u>**

- Rent from land is **land income** 2.000 (being non commercial, cadastral value is used instead);
- Dividends is income from capital for an amount of 500 (tax law provides for an exemption of 50% for non commercial entities);
- Total Income: 2.500;
- Total Income Tax: 2.500 x 24% = **600 Euro**.

# Loss of the status of «non-commercial entity»

**Art. 149, par. 1**

«*Regardless of the statutory provisions, the entity loses the status of non-commercial entity if it mainly carries out commercial activities (on the basis of article 55) for an entire tax period*».

Legal presumption

- **Consequences**
- Change in income determination rules;
- Subjection to VAT of all active operations including typically institutional income;
- Inclusion of all corporate assets in the inventory;
- Effectiveness of the loss: RETROACTIVE, starting from the beginning of the tax period in which the conditions that allow for the benefit of the concessions cease to exist.
- The provisions on the loss of qualification do not apply:
- to ecclesiastical entities recognized as juridical persons for civil purposes;
- to amateur sports associations.

# Highlights

In Italy, the type of direct taxation which weighs on business activities **depends on the nature of the taxable person** (natural persons or legal persons) and on their organization (partnership or limited liability company).

In general, self-employed workers and sole proprietorships are subject to PIT, while legal entities (with the notable exception of partnerships) are subject to IRES, corporate income tax.

| Corporate Income Tax | Personal Income Tax |
|---|---|
| ONLUS (bonyads) only for some kinds of income | Small Business |
| Cooperatives | Self-employed |
| Limited Liability Companies | Employee |
| Capital Companies | Partnerships based on their share (taxation for transparency) |
| Commercial and non-commercial entities | Occasional workers (art. 67) |

# Thanks for your attention

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