

Allowance for Growth and Investment

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DEFINITIONS

- **ACE**: means Italian the allowance for corporate equity governed by ACE Decree
- **ACE Decree**: means the Decree of the Italian Ministry of Finance dated March 14, 2012, which implements the (Italian) ACE technical rules
- **AGI**: means the allowance for growth and investment laid down in Art. 11 of the (Directive) Proposal
- **(Directive) Proposal**: means the Proposal for a Council Directive on a Common Corporate Tax Base (COM(2016) 685 final) released by the European Commission on October 25, 2016
- **GAAR**: means the general anti-avoidance rule
- **ITA**: means the Italian Tax Authorities (*Agenzia delle Entrate*)
- **SAAR(s)**: means specific anti-avoidance rule(s)

THE RATIONALE OF AGI

- ✓ *"The Allowance for Growth and Investment grants deductions for financing costs for debt and equity within limits to avoid abuses and tax planning"* (**Explanatory Memorandum, § 3**)

- ✓ *"The distortions in the financing decisions of companies are reduced with an Allowance for Growth and Investment, which puts equity and debt financing on similar footing"* (**Explanatory Memorandum, § 3**)

THE RATIONALE OF AGI

"The re-launch initiative aims to tackle the asymmetry whereby interest paid out on loans is deductible (subject to some limits) from taxpayers' common base whilst this is not the case for profit distributions. The outcome is a definitive advantage in favour of financing through debt as opposed to equity. Given the risks that such a situation entails for the indebtedness of companies, the re-launch proposal for a common corporate tax base will include a rule against debt bias, in order to neutralise the current framework that discourages equity financing. Taxpayers will be given an allowance for growth and investment according to which increases in their equity will be deductible from their taxable base subject to certain conditions, such as measures against potential cascading effects and anti-tax avoidance rules. As part of the review of the common tax base, the Commission shall give specific consideration to the functioning of the AGI as a basis for considering adjustments to its definition and calibration." (**Explanatory Memorandum, § 5** – emphasis added)

PREVENTING TAX AVOIDANCE OUTCOMES

Anti-Avoidance

✓ *"[… omissis …] Thus, it would be essential to ensure that the system does not suffer cascading effects and to this end, it would be necessary to exclude the tax value of a taxpayer's participations in associated enterprises. Finally, to make the scheme of the allowance sufficiently robust, it would also be required to lay down anti-tax avoidance rules."* (**Preamble # 10 –** emphasis added)

Risk of High Costs of Compliance

✓ *"Businesses rather emphasize the importance of reducing compliance costs and creating a business-friendly environment for investment. Yet, they also highlight risks in incurring higher administrative costs if the rules against tax avoidance dominate the system."* (**Explanatory Memorandum, § 3 – Stakeholders Consultations –** emphasis added)

PREVENTING TAX AVOIDANCE OUTCOMES

Delegated Powers to the Commission to lay down anti-avoidance provisions

- ✓ *"In order to supplement or amend certain non-essential elements of this Directive, the power to adopt acts in accordance with Article 290 of the Treaty on the Functioning of the European Union should be delegated to the Commission with respect of* […*omissis*…] *(iii) enacting detailed rules against tax avoidance in a number of specified fields relevant to the allowance for growth and investment* […*omissis*…]" (**Preamble # 13 –** emphasis added)

- ✓ *"The Commission shall be empowered to adopt delegated acts in accordance with Article 66 to lay down more detailed rules against tax avoidance, and more particularly in the following fields relevant to the AGI …"(***Art. 11(6) –** emphasis added)

CHECK-UP ON THE FUNCTIONING OF AGI

Check-up on the functioning of AGI

- ✓ "[*…omissis…*] *the Commission shall, three years after the entry into force of this Directive, examine the functioning of Article 11 and consider adjustments to the definition and calibration of the AGI. The Commission shall undertake a thorough analysis of how the AGI can encourage companies that are entitled to opt for applying the rules of this Directive to finance their activities through equity".* (**Directive) Proposal Article 69(2) –** emphasis added)

CORE OF THE AGI PROVISION

AGI Equity Base Increase x Defined Yield = Tax Deductible Item

AGI Equity Base Decrease x Defined Yield = Taxable Item

OPEN ISSUES

1) May the Tax Deductible Item create a tax loss (*i.e.* when its amount is higher than the taxable income prior to the computation of AGI)?

2) In case of a negative answer (like in Italy), where the Tax Deductible Item is higher than the taxable income prior to the computation of AGI may the difference be carried forward to the subsequent years (like in Italy)?

EQUITY BASE

AGI Equity Base ➔ In any given taxable year, it is the difference between:

(i) the Equity value of a Taxpayer; and

(ii) the *tax value* (not accounting!) of its participation(s) in the capital of Associated Enterprise(s)

✓ The netting of the tax value of Taxpayer's participations in the capital of Associated Enterprises from the AGI Equity Base aims at preventing AGI cascading effects

Meaning of "Tax Value"

- ✓ The syntagm "*tax value*" is not defined in the (Directive) Proposal ➔ The expression "*value for tax purposes*" is defined at Art. 4(17). However, it has a meaning that should not apply to participations as it means "*the depreciation base of a fixed asset or asset pool, less total depreciation deducted*".
- ✓ Art. 4(20) defined "Financial Assets" *inter alia* as "*shares in … Associated Enterprises*"
- ✓ Art. 38 provides that *inter alia* Financial Assets "*shall not be subject to depreciation*" ➔ Art. 4(17) should not apply to participations in Associated Enterprises
- ✓ Hence, should it be made reference to the "Tax Value" defined by:
  - (a) Art. 20(1)(a) as "*the monetary consideration for the transaction*" in case of participations in Associated Enterprises accounted for as Financial Assets?
  - (b) Art. 20(1)(d) as "*the market value of financial assets and liabilities held for trading*" in case of participations in Associated Enterprises accounted for as "Held for Trading" (IAS 39.9)?
- ✓ Given the purposes of the AGI anti-avoidance rules (*i.e.* avoiding duplicating and cascading effects), reference to the market value should always be disregarded ➔ the expression "*Tax Value*" should be construed as the purchase price of, or the amount(s) of the cash injection(s) made to the equity of, the Associated Enterprise(s)

AGI EQUITY BASE - INCREASE / DECREASE

Increase / Decrease is the 10 years (positive / negative) difference between the *(i)* AGI Equity Base at the end of the relevant year (X) and *(ii)* AGI Equity Base at the end of the 10th preceding year (X – 10).

For the first 10 years of application of AGI, the subtrahend is the value of the AGI Equity Base computed as at the last day of the tax year preceding that of the first application

AGI EQUITY BASE

Equity: means "*Capital and Reserves*" as described in the EU accounting directive (Directive 2013/34/EU) or "*Equity*" and described under IAS/IFRS (Reg. no. 1606/2002)

Defined Yield: is equal to the yield of the Euro area 10-year government benchmark bond in December of the year (X -1) preceding the relevant tax year (X), as published by the European Central Bank, increased by a risk premium of two percentage points.

A floor of two per cent shall apply where the curve of the annual yield is negative ➔ Minimum 2%

ANTI-AVOIDANCE PROVISIONS

- ✓ The AGI shall be subject to certain conditions in order to prevent potential cascading effects and abuses/double dips

- ✓ Article 11(6) of the (Directive) Proposal empowers the Commission to enact anti-tax avoidance rules in a number of specified fields relevant to the AGI, *inter alia*, the followings:

SITUATIONS TO BE ADDRESSED BY ANTI-AVOIDANCE RULES

a) Intra-group loans and loans involving associated enterprises;

b) Cash contributions and contributions in kind;

c) Transfers of participations;

d) Re-categorization of old capital as new capital through liquidations and creation of start-ups;

e) Creation of subsidiaries;

f) Acquisitions of businesses held by associated enterprises;

g) Double-dipping structures combining interest deductibility and deductions under the AGI;

h) Increases in the amount of loan financing receivables towards associated enterprises as compared to the amount of such receivables at the reference date

COMPARISON BETWEEN AGI AND ACE

	ACE (ITALY)	AGI (EU)
Subjective scope (comparable)	Italian resident companies and PEs of non-Italian resident entities	EU resident qualifying companies and PEs of entities resident in another EU country/third State
Yield (comparable w/respect to the underlying principle)	It is determined on yearly basis by a Ministerial Decree to be issued within the 31 January of each year. In determining the yield, the Italian Government takes into consideration the yield of the Italian government bond in the preceding year (increased by a risk premium)	It amounts to the yield of the euro area 10-year government benchmark bond in December of the year preceding the relevant tax year, (increased by a risk premium of two percentage points). Minimum 2%
Equity Base (Not procedurally comparable)	Equity value as at 31 December 2010 (netted of the 2010 net profit)	Equity value - tax value of the participation(s) in the capital of Associated Enterprise
Specific adjustments to Equity Increase/Decreases (not comparable)	YES (see Appendix)	Aspect not addressed by the (Proposal) Directive
Relevance of the timing of the Increase/Decreases (not comparable)	YES (see Appendix)	Aspect not addressed by the (Proposal) Directive
Excess of Tax Deductible Item - Carry forward/tax Credit (not comparable)	YES ACE cannot result in a tax loss for the taxpayer Carry forward mechanism (without time limitations) Excess ACE may also be turned into a IRAP tax credit	Aspect not addressed by the (Proposal) Directive
Taxable Item (not comparable)	No. The application of ACE can never result in a taxable item	YES
GAAR (comparable)	YES	YES
SAAR(s) (to be verified)	YES	To be further addressed by the Commission

COMPARISON BETWEEN AGI AND ACE

- ✓ While increases/decreases relevant for AGI Equity Base are those having direct effects on the accounting net equity, increases/decreases relevant for ACE Equity Base may depart from the accounting representation of the net equity.

  - ➢ increases relevant for ACE Equity Base are only those arising from a cash contribution or net profit allocated to reserves;

  - ➢ decreases relevant for ACE Equity Base are only those resulting from a distribution of cash/assets/reserves to the shareholders (as well as those deriving from the application of the anti-abuse provisions).

    In this respect, the employment of reserves to cover losses does not amount to a decrease relevant for ACE Equity Base.

COMPARISON BETWEEN AGI AND ACE

- ✓ **Mergers, Divisions, Partial Divisions, Transfer of Assets** ➔ Neither (Directive) Proposal nor ACE Decree provide for a specific set of rules governing the operations concerned.
- ✓ As far as the application of **ACE** in connection with domestic **Mergers, Divisions, Partial Divisions**, is concerned, Italian Tax law provides for a specific limitation to the transfer of the Excess ACE pertaining to the companies involved in the reorganization ➔ In a nutshell, each company concerned is entitled to transfer to the receiving company its Excess ACE, accrued prior to the reorganization, up to the amount of its (adjusted) accounting net equity.
- ✓ As with regard to the **transfer of the tax residence to Italy** carried out by persons eligible for ACE, Italian Tax Authorities (Circular Letter No. 12/E 2014) hold that Equity Base relevant for ACE purposes is to be determined taking into consideration ACE increases/decreases occurred starting from 1 January 2011 (i.e. ACE increases/decreases occurred prior to the migration are to be included within the Equity Base relevant for ACE purposes) ➔ The same rule should apply to Intra-EU Mergers and Divisions where the receiving company is resident for tax purposes in Italy .
- ✓ **(Directive) Proposal does not address** the application of **AGI** in connection with domestic/Intra EU Mergers, Divisions, Partial divisions, Transfer of Assets.

TACKLING ABUSES OF THE AGI(ACE) BENEFIT: THE ITALIAN APPROACH (1/2)

- ✓ Italy implements a two-pronged approach to counteract abuse of the ACE benefit, combining SAARs, contained in the ACE Decree, and a GAAR, laid down in Article 10-*bis* (Abuse of Law) of Law no. 212 of 2000 (Taxpayers Bill of Rights)

- ✓ The rationale of the ACE SAARs is to prevent undue duplications of the same ACE benefit between related entities. Italian SAARs are designed to cover specific situations, including those listed in letters (a), (b), (e), (f) and (h) of Article 11(6) of the Proposal and have been interpreted extensively by ITA

- ✓ Cases of abuse – such as double-dipping structures combining interest deductibility and ACE deductions – which are not covered by the SAARs may nonetheless fall under the GAAR

TACKLING ABUSES OF THE ACE BENEFIT: THE ITALIAN APPROACH (2/2)

- ✓ SAARs normally apply to certain transactions between the eligible company and either *(i)* its subsidiaries or *(ii)* its sister companies (provided that such other companies are either resident in Italy or have a permanent establishment in Italy to which to financial flows relate to).
- ✓ In the opinion of the ITA, contributions from black-listed entities are neutralized for ACE purposes regardless as to whether the latter are part of the same group (Circ. Lett. 21/E of 2015, § 3.8) and of the percentage of the capital (directly or indirectly) held by the black listed entity
- ✓ SAARs ordinarily operate on the ACE base of the eligible company that makes the tainted transaction (cash contribution / transfer of business or participations/loan etc.). However, in case of equity transfer from a foreign entity, the ACE base of the receiving entity is neutralized
- ✓ However, taxpayers may apply for a ruling with the ITA to seek the non-application of the SAARs. They must prove that there has not been any duplication of the ACE benefit.

INTRA-GROUP LOANS AND LOANS BETWEEN ASSOCIATED ENTERPRISES (Art. 11(6)(a) and (h))

- ✓ The ACE base is netted by the increases in the amount of loan and receivables (having financial nature) towards subsidiaries and sister companies as compared to the amount of such receivables in the company's balance sheet on December 31, 2010

- ✓ The downward adjustment operates on the ACE base of the lender and only targets receivables between companies part of the same group at the end of the relevant FY

- ✓ The underlying rationale is to avoid the same contribution to duplicate the ACE base of different group entities ➔ This would occur where company A receives 100 of equity and lends it out to company B, which in turn contributes the same equity to company C

CASH CONTRIBUTIONS AND CONTRIBUTIONS IN KIND
(Art. 11(6)(b))

- ✓ The ACE base is netted of any intra-group equity cash contribution made by an eligible company to its (eligible) subsidiaries or sister companies as of 1 January 2011 (since they are added to the ACE base of the receiving entities) originating from:
  - a) non-resident persons if such persons are, in turn, controlled by Italian resident persons which are part of the same group as the contributing and the receiving entities;
  - b) persons that are in resident in black list countries regardless of whether such persons are part of the same group as the receiving entity

- ✓ In case of cash contribution made between two resident companies, the ACE base is reduced at the level of the contributing company

- ✓ In cases (a) and (b) above (X-border transactions), the ACE base is reduced at the level of the receiving entity

- ✓ Contributions in kind are not relevant for ACE purposes

CASH CONTRIBUTIONS FROM BLACK-LISTED SHAREHOLDERS (1/2)

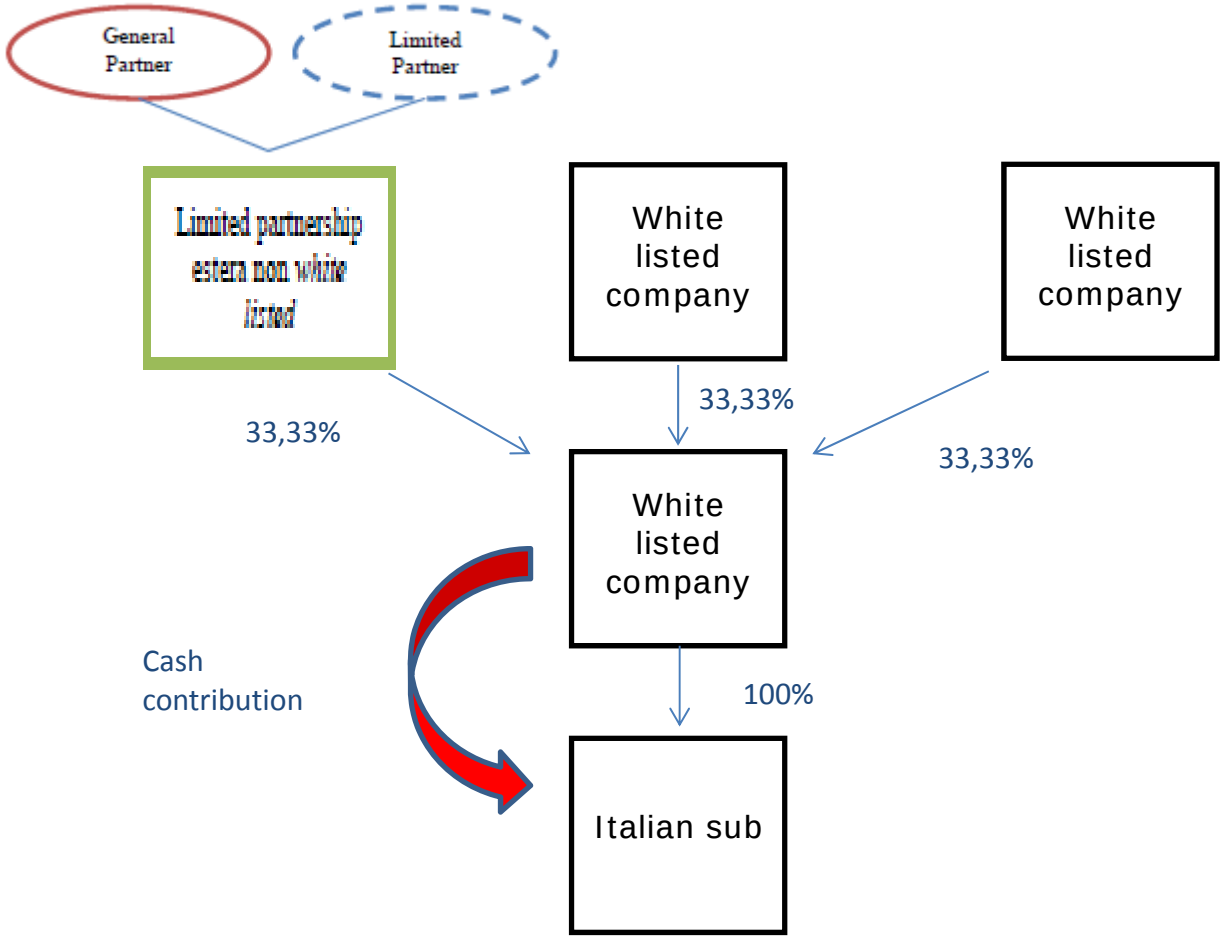
- ✓ To determine the real source of the cash contribution, the ITA do not just look at the shareholder formally making the equity contribution but adopt a look-through approach (ITA Circular Letter no. 21/E of 2015, § 3.10) ➔ It is not sufficient to channel the equity contributions via a "white-listed" company to prevent the ACE base reduction

- ✓ Carve-out for listed companies: the look-through analysis shall only be made with respect to white list shareholders holding a qualified interest (> 3%) in the listed company (ITA Circular Letter no. 21/E of 2015, § 3.9)

CASH CONTRIBUTIONS FROM BLACK-LISTED SHAREHOLDERS (2/2)

In the view of the ITA, the mere presence of minority black-listed shareholders' may taint the whole cash contribution to the Italian sub.

Cash contributions from group companies directly or indirectly participated by black listed shareholders – whether majority or not – shall be fully (*i.e.* not for the portion originating from such shareholders) neutralized, unless the receiving entity proves that the relevant cash contribution did not generate double deductions (ITA Circular Letter no. 21/E of 2015, § 3.10)



TRANSFERS OF PARTICIPATIONS (Art. 11(6)(c))

✓ As per Article 10(3)(a) of the ACE Decree, the ACE base (of the acquirer) is netted of the price paid to

a) acquire controlling interests in subsidiaries provided that the seller is an Italian resident entity (or an Italian PE) part of the same group of the acquirer;

b) increase already existing equity interests in subsidiaries belonging to the same group

✓ The acquired participation must be a majority shareholding (*i.e.* controlling stake)

✓ The rule applies even if, at the end of the relevant FY, the acquirer is not part of the same group of the seller

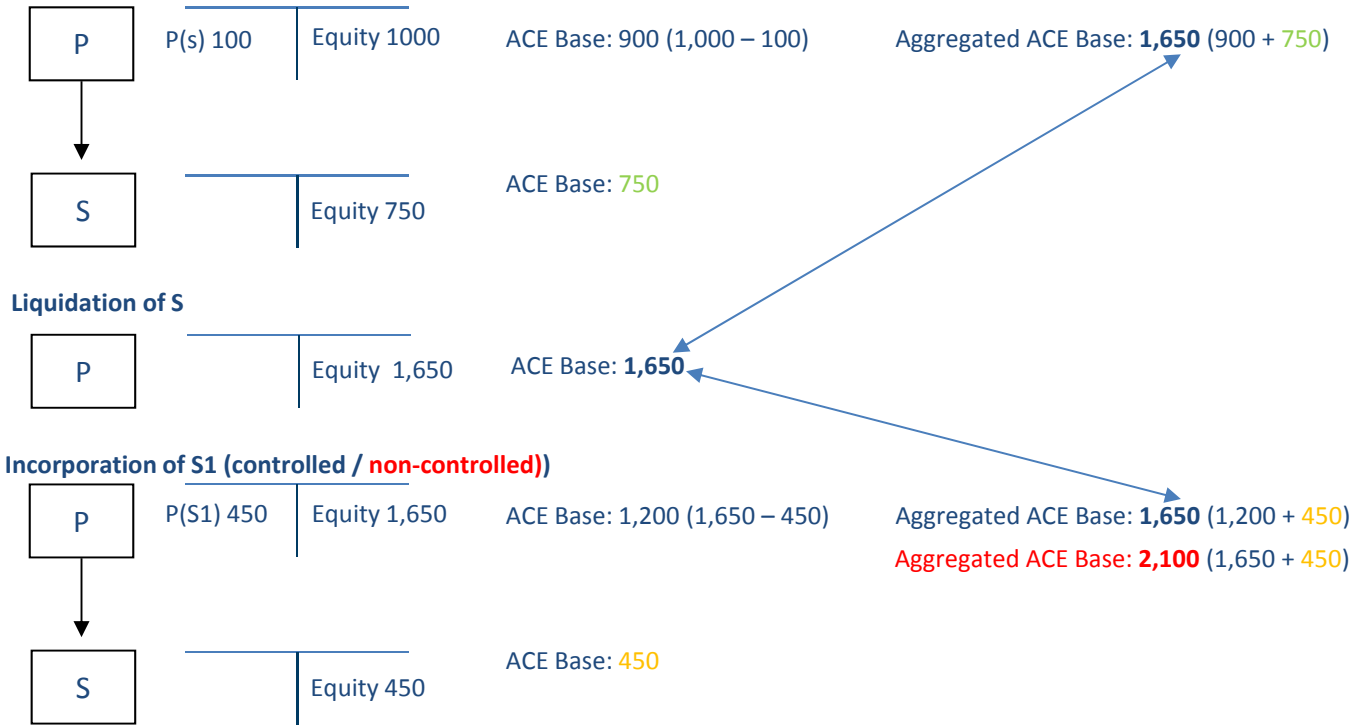
➔ **The intragroup purchase of majority participations are netted from the ACE Base of the purchaser**

➔ **In AGI the Equity value is reduced by the tax value of the participation in an Associated Enterprise (not only controlling interest - enough more than 20%)**

THE RE-CATEGORISATION OF OLD CAPITAL AS NEW CAPITAL..... (Art. 11(6)(d)) (1/2)

- ✓ The Italian rules do not explicitly cover the situation where an existing subsidiary is liquidated and a (controlled) Newco is incorporated. However, under Italian rules this transaction is neutral for ACE purposes. They would not be neutral if Newco is not controlled (in the context of **AGI**, if Newco disqualifies as Associated Enterprise)

- ✓ Example (old subsidiary with retained earning)



THE RE-CATEGORISATION OF OLD CAPITAL AS NEW CAPITAL…… (Art. 11(6)(d)) (2/2)

- ✓ An hypothesis where the liquidation of an existing controlled subsidiary and the incorporation of a Newco may be beneficial for AGI purposes is where Newco disqualifies as Associated Enterprise. In this case, the AGI Base of the parent company would not be reduced by the tax value of the participation in Newco

- ✓ However, in this case the anti-avoidance principle laid down at paras (6)(b) and/or (e) could come into play (*i.e.* these rules could apply as to whether or not the "*cash contribution*" is made to an Associated Enterprise or to a "*subsidiary created*") and sterilize the AGI base of the parent company.

CREATION OF (CONTROLLED) SUBSIDIARIES (Art. 11(6)(e))

- ✓ As a rule, cash contributions made by an eligible company to its newly incorporated controlled subsidiaries or sister companies as of 1 January 2011 reduce the ACE base of the contributing entity and add up (only) to the ACE base of the receiving entity (Article 10(2) of the ACE Decree)
- ✓ These cash contributions are neutralized even if, at the end of the relevant FY, the receiving entity is any longer part of the same group
- ✓ Contributions in kind do not reduce the ACE base of the contributing entity and are not relevant for that of the receiving entity
- ✓ **AGI**: what is the difference between the "*creation of start-ups*" mentioned at Art. 11(6)(d) and the "*creation of subsidiaries*" mentioned at Art. 11(6)(e)?

ACQUISITIONS OF BUSINESSES HELD BY ASSOCIATED ENTERPRISES (Art. 11(6)(f))

- ✓ The ACE base is netted of the price paid to acquire businesses (or part of businesses) already held by subsidiaries or sister companies (Article 10(3)(b) of the ACE Decree)

- ✓ The seller must be a company or an Italian permanent establishment part of the same group of the purchaser

- ✓ Payments in kind do not reduce the ACE base (*i.e.* only payments in cash are neutralized for ACE purposes)

DOUBLE DIPPING (Art. 11(6)(g))

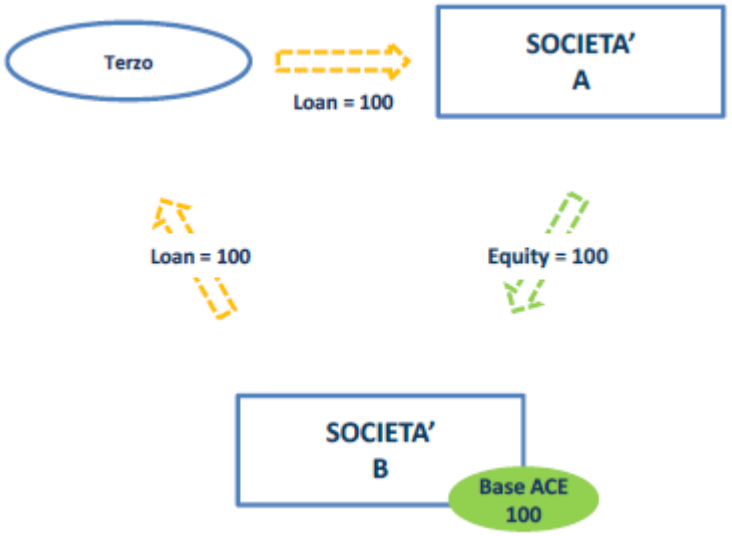
- ✓ No specific provisions under Italian law.
- ✓ GAAR may apply

OTHER ABUSIVE TRANSACTIONS (GAAR)

- ✓ Other non-listed transactions may nonetheless fall within the scope of the GAAR (Article 10-*bis*, Law no. 212 of 2000 (Taxpayers Bill of Rights)) if they
  - a) lack of economic substance
  - b) result in an undue tax benefit
  - c) The tax benefit is the essential scope of the transaction

Parent Company A borrows €100 from C, a third party (e.g. bank), and then contributes them to its subsidiary B. B in turn lends the same equity to C and closes the transaction as a circle.

The equity injection made by A to B is neutralized under Art. 10(2) of the ACE Decree, while the correspondent increase in the ACE base of B may be neutralized under the GAAR, since (i) the transaction is circular and lacks of economic substance; (ii) the equity is, in reality, financing; (iii) allowing B an ACE benefit is the essential scope of the transaction (Circ. Lett. no. 21/E of 2015, § 3.11)



APPENDIX

✓ **The following operations give rise to an increase of the Equity Base relevant for ACE purposes:**

[cash contributions and retained earnings]

- cash contributions;
- capital increase through the set off of shareholder's receivables;
- allocations of profit to reserves (except non-distributable reserves);
- the granting of non-refundable shareholder loans;
- the waiver of repayment of refundable shareholder loans;

✓ **The following operations give rise to a decrease of the Equity Base relevant for ACE purposes:**

[distribution of cash/assets/reserves to the shareholders giving rise to a reduction of the net equity]

- distributions of retained earnings/capital to shareholders;
- the purchase of a participation in a controlled entity;
- the purchase of a going concern belonging to a controlled entity;
- the Equity Base decreases resulting from the application of anti-abuse rules.

✓ **Relevant Timing**

- contributions in cash (and non-refundable shareholder loans) produce effects starting from the date when they are physically carried out (pro-rata basis criterion);
- capital increases through the set off of shareholder's receivables (and waivers of repayment of refundable shareholder loans) produce effects starting from the date when the set off or the waiver are effective;
- Allocations of profit to reserves produce effects starting from the first day of the financial year in which they occur;
- Equity Base decreases produce effects starting from the first day of the financial year in which they occur.