TMC
TAX | ADVISORY | LEGAL

www.tmcadvisory.com

VERONA
MILANO
FERRARA
VARESE
BOLOGNA
MUNCHEN
KOLN
GIJÓN

INTERNATIONAL
TAX FOCUS

# Taxation of foreign funds investing in Italy


1. Foreword 2

2. Dividends distributed to foreign funds 2

- 2.1 Exemption from withholding 2
- 2.2 1.20% EU/EEA reduction 3
- 2.3 Tax Treaty reduction 3
- 2.4 Pension funds 3

3. Interest distributed to foreign funds 4

- 3.1 Withholding exemption for medium-long term loans 4
- 3.2 Tax Treaty reduction 4
- 3.3 Interest received under certain kind of bonds 4

4. Proceeds from Italian fund 5

- 4.1 Exemption from withholding 5
- 4.2 Tax Treaty reduction 5

5. Capital gains on securities 6

- 5.1 Domestic exemption 6
- 5.2 Tax Treaty reduction 6

6. Glossary 7

## 1. Foreword

As the importance of investment funds has grown throughout the years, given their ability to raise relevant amount of money and invest it, the features of the taxation of their return have been under the spotlight. The Italian legislator has amended the main rules related to the taxation of foreign investment returns several times during the last decade with the main goal of rendering investments in Italy more attractive from a tax perspective.

One of the principles that has driven such amendments is that the taxation of fund proceeds should usually occur at the level of the investors in the fund; accordingly, several rules providing for exemption on outbound flows income have been enacted.

In addition, the interplay between domestic rules and EU law has raised attention as some of the Italian domestic provisions have been found to be contrary to the EU fundamental freedoms.

## 2. Dividends distributed to foreign funds

As a general rule, dividends distributed by Italian companies to foreign funds are subject to a final 26% withholding. However, depending on the circumstances, some exceptions may apply.

### 2.1 Exemption from withholding

***Dividends paid to EU and EEA funds***

Dividends paid by Italian companies may benefit from an exemption from the Italian domestic withholding to the extent that such foreign investment funds are established in a EU Member State or in a EEA State allowing for an adequate exchange of information with Italy and are:

- compliant with Directive 2009/65/EC (UCITS IV Directive); or
- even if not compliant with the above-mentioned Directive, managed by management company which is subject to forms of supervision in the country of establishment in accordance with Directive 2011/61/EU (AIFM Directive).

This exemption has been only recently enacted (Law no. 178 of 30 December 2020, Budget Law for 2021) in order to avoid the treatment of EU funds to be considered discriminatory compared to the Italian ones (as these lasts do not suffer any withholding nor are subject to taxation in Italy with respect to the dividends received form Italian companies).

As already pointed out by the Italian Tax Authorities (ruling no. 327 of 11 May 2021), the only requirements provided for by the new exemption rule are of a regulatory nature. Accordingly, all the other features of the relevant EU or EEA funds remain irrelevant, including tax features (as the exemption applies regardless to the circumstances, for instance, that the relevant EU or EEA fund is considered tax resident in its Country of establishment or not).

Pursuant to the Budget Law for 2021 (as also confirmed by the FAQ published by the Italian Tax Authorities on 8 April 2022) the exemption should only apply with respect to dividends distributions occurred as of 1 January 2021. However, as such exemption was enacted (as also stated by the explanatory memorandum to the Budget Law 2021) to prevent Italian rules to be in breach of EU law, there are arguments to maintain that such exemptions should have been considered to be applicable even prior to that day.

***Dividends paid to third Country funds***

The language of the Budget Law for 2021 makes it clear that the exemption provided for by EU and EEA funds does not apply to third Country funds. However, the Italian Supreme Court has recently issued a series of decisions (decisions no. 21454, 21475, 21479, 21480, 21481 and 21482 of 6 July 2022) stating that a difference in the tax treatment between dividends distributed to Italian funds and to third Country funds shall be considered discriminatory and contrary to the principle of free movement of capital enshrined in Art. 63 of the TFUE.

As this principle also applies with respect to third Country investors, dividends paid by Italian companies to third Country funds shall receive the same tax treatment of dividends paid to Italian funds. From this, should follow that dividends paid to third Country funds should benefit from an exemption as well as Italian and EU/EEA funds.

However, the Italian legislation does not yet provide for such exemption.

## 2.2 1.20% EU/EEA reduction

Pursuant to its language, the 1.20% reduction provided for by Italian domestic law (Art. 27(3-*ter*) of the Presidential Decree no. 600/1973) in favour of entities which are resident (*i.e.* liable to tax) in white-listed EU or EEA countries seems to be applicable even to foreign funds fulfilling such requirements.

However, with a recent statement of practice (ruling no. 338 of 23 June 2022), the Italian Tax Auhtorities have denied the application of such reduced withholding to a foreign pension fund on the basis that such does not carry out any commercial activity. The Italian Tax Auhtorities' opinion is in contrast with the position of the Italian Supreme Court which has repeadetly maintanined (see, decision no. 5152 of 16 February 2022) – with respect to pension funds – that the 1.20% reduction shall apply also to (pension) funds, hence regardless to any commercial activity requirement.

## 2.3 Tax Treaty reduction

Where the exemption described in the previous paragraphs is not applicable, the ordinary 26% rate on outbound dividends payments may still be reduced where a tax treaty is applicable.

In order for the tax treaty concluded between Italy and the Country of residence of the relevant fund to apply, certain specific requirements need to be met. In particular, the foreign fund needs to qualify as a "person" and as "resident" under the relevant tax treaty.

As the concept of person is interpreted quite broadly, usually funds are considered to qualify as such under treaty law even though some specific treaties explicitly address the issue.

As far as the residency requirement is concerned, a general liability to tax is usually considered to suffice (*i.e.* there is no need for the fund to be actually subject to taxation. This is the approach the Italian Tax Authorities have taken with respect to Italian domestic funds which are considered to be treaty entitled even if they – generally – benefit from a full direct taxes exemption; see Circular letter no. 2 of 15 February 2012). However, where the fund is not considered to be resident under the relevant treaty (hence, such treaty is not applicable), pursuant to the OECD clarifications (also accepted by the Italian Tax Authorities), the treaty(ies) between Italy and the investor(s) may directly apply (where all the conditions for such treaty(ies) to applied are met).

With specific respect to dividend distributions, in order for its reduced rate to be applicable, Art. 10 of the OECD Model Convention requires the relevant fund to qualify as the beneficial owner of such income.

In addition to all the above, a peculiar (and quite unclear) set of rules is provided for by Art. 10-*ter* of Law no. 77 of 23 March 1983. In particular, paragraph 8 of such article provides that, with respect to their investments in Italy, certain kind of foreign funds may benefit from the relevant double tax treaty in proportion to their quotas which are held by investors residing in Countries having a double tax treaty in place with Italy. This only to the extent that (as clarified by the following paragraph 9) such funds are established in a Country which applies the same kind of treatment to Italian funds investing therein.

## 2.4 Pension funds

A specific rule is set forth by Art. 27(3) of the Presidential Decree no. 600/1973 with respect to some kinds of foreign pension funds. Where these kinds of funds are:

- established in an EU or EEA Country; and
- carry out activities equivalent to the ones carried out by Italian complementary pension funds,

then a reduced 11% withholding shall apply to Italian sourced dividend distributions.

Nonetheless, the Italian Supreme Court has repeatedly stated that (among the others, decision no. 25963 of 2 September 2022) that the 11% rate must be applied also to non-EU funds. According to the Supreme Court's reasoning, as the principle of free movement of capital applies also with re-

spect to third Countries, the difference in treatment between EU/EEA and third Country funds shall be considered of a discriminatory nature.

*Italian sourced dividends distributed to foreign funds*

| Favourable regime | Eligible funds |
|---|---|
| **Exemption** | EU or EEA funds |
| **1.20% reduction** | N/A |
| **Treaty reduction** | Funds must be a person resident in the other Contracting State and beneficial owner |
| **11% reduction** | EU or EEA pension funds |

# 3. Interest distributed to foreign funds

As already highlighted with respect to dividends, as a general rule, interest paid by Italian tax residents are usually subject to a 26% rate withholding in Italy (expect for the cases where the payer does not qualify as a withholding agent in Italy).

However, there are several rules and exemptions that apply in order to lower such tax burden.

## 3.1 Withholding exemption for medium-long term loans

A full exemption from withholding is provided for interest paid:

- under medium-long term loans (meaning loans having a maturity longer than 18 months);
- to funds subject to supervision in their Country of establishment, even though not liable to tax therein. The Country of establishment must allow for a satisfactory exchange of information with Italy (those Countries are listed in the Ministerial Decree of 4 September 1996);
- by borrowers qualifying as Italian enterprises. According to the Italian Tax Authorities (ruling no. 98 of 5 April 2019), with respect to this rule, the term "enterprises" only encompasses companies and entities carrying out a commercial activity (as listed in Art. 73(1)(a) and (b) of the TUIR) as well as entrepreneurs and permanent establishments of foreign enterprises.

In addition, the Italian Tax Authorities have clarified (among the others, see ruling no. 79 of 12 August 2019) that such exemption is only available where the first recipient of the interest payment qualifies as a fund (or as one of the other entities that are eligible for the exemption). Where the fund is the beneficial owner of the income but has interposed another entity which actually receives such income a look through approach cannot be applied and the exemption will not be available.

## 3.2 Tax Treaty reduction

As already highlighted for dividends payment (§ 2.3 above) where the conditions for the exemption to apply are not met, foreign funds receiving Italian sourced interest may still, under certain conditions, benefit from a reduction of the 26% taxation pursuant to the applicable tax treaty.

The conditions for the treaty to apply are the same already described with respect to dividend distributions, namely:

- the fund must qualify as a "person" under the relevant treaty;
- the fund must qualify as a "resident" of the other Contracting State under the relevant treaty;
- the fund must qualify as a the "beneficial owner" of the relevant income, in order for the reductions usually provided therein to be available.

In addition, as also highlighted with respect to dividend distributions, the provisions of Art. 10-*ter*(8) and (9) of Law no. 77 of 23 March 1983 should be applicable.

## 3.3 Interest received under certain kind of bonds

Where interest received by foreign funds are paid under bonds:

- issued by Italian banks;
- issued by Italian limited liability companies per shares whose shares are listed in a regulated market or a multilateral trading facility of an EU or EEA Country;
- traded in the same markets mentioned in the bullet above;
- held by one or more institutional investors (under the meaning of Art. 100 of the Legislative Decree no. 58 of 24 February 1998);

then an exemption might be available for foreign funds which have invested in such bonds.
The exemption is available to the extent that such foreign funds qualify as "institutional investors" under the meaning of Art. 6 of the Legislative Decree no. 239 of 1 April 1996 and are established in Countries allowing for a satisfactory exchange of information with Italy that are listed in the Ministerial Decree of 4 September 1996.
On top of the substantive requirements described above, some specific formal requirements need to be fulfilled in order for the exemption at stake to be enjoyed.

*Italian sourced interest distributed to foreign funds*

| Favourable regime | Eligible funds |
| --- | --- |
| **Exemption** | White-listed funds subject to supervision |
| **DLgs. 239/1996 exemption** | White-listed funds subscribing particular kind of Italian bonds |
| **Treaty reduction** | Funds must be a person resident in the other Contracting State and beneficial owner |

# 4. Proceeds from Italian funds

Even with respect to proceeds paid by the Italian resident funds to foreign funds, as a general rule, a 26% rate withholding tax applies. Also in these kinds of distributions, however, several rule may kick-in to reduce such tax burden.

## 4.1 Exemption from withholding

An exemption from Italian taxation is provided with respect to proceeds paid by Italian real estate funds and other kind of Italian established funds to certain foreign quota holders. As a preliminary remark, it is important to notice that funds proceeds include proceeds distributed during the period in which the Italian fund is operating and the investor is a quota-holder as well as the ones embedded in the difference between the value of acquisition of the quotas and their redemption, liquidation or sale value.

With respect to foreign investors into Italian real estate funds, no withholding is applied (pursuant to Art. 7(3) of Law Decree no. 351 of 25 September 2001) on proceeds received by:

- certain kind of European pension schemes (the so-called pan-European Personal Pension Product or PEPP);
- white-listed foreign funds.

A similar exemption rule is provided for by Art. 26-*quinquies*(5) of the Presidential Decree no. 600/1973 with respect to Italian funds other than real estate funds (even if established in corporate form – so called SICAF or SICAV). The article provides for an exemption from the 26% rate withholding with respect to proceeds which are distributed to quota-holders qualifying as, among the others, "institutional investors" under the meaning of Art. 6 of the Legislative Decree no. 239 of 1 April 1996 and are established in Countries allowing for a satisfactory exchange of information with Italy that are listed in the Ministerial Decree of 4 September 1996.

## 4.2 Tax Treaty reduction

Where the requirements for the exemptions provided above are not met, the 26% withholding may still be reduced pursuant to the applicable tax treaty entered into by Italy and the Country of residence of the relevant foreign recipient fund. Even in this case, for the treaty to apply, it is necessary

that the relevant fund is entitled to its benefits. With this respect, the same considerations set forth under § 2.3 and 3.2 above apply.

According to several Italian Tax Authorities statements of practice (see, among the others, Circular letter no. 2 of 15 February 2012) with respect to such proceeds, Art. 11 of the OECD Model Convention (the one governing the taxation of interest) should apply.

***Italian sourced fund proceeds paid to foreign funds***

| Favourable regime | Eligible funds |
|---|---|
| **Exemption** | "Institutional investors" white-listed RE funds / white-listed non-RE funds |
| **Treaty reduction** | Funds must be a person resident in the other Contracting State and beneficial owner |

# 5. Capital gains on securities

Capital gains on securities located in Italy are usually subject to a substitute tax at a 26% rate. Nonetheless, the taxation can be reduced or, in some cases zeroed where certain conditions are met.

## 5.1 Domestic exemption

Pursuant to Art. 5 of the Legislative Decree no. 461 of 21 November 1997, the 26% substitute tax provided for capital gains on Italian securities is not applicable where the holders of such securities (other than non-portfolio participations) are specific kinds of foreign investors resident or located in Countries allowing for a satisfactory exchange of information with Italy that are listed in the Ministerial Decree of 4 September 1996. Usually, foreign funds qualify for such exemption.

In addition, capital gains derived by foreign investors on Italian securities might be considered as not sourced from Italy (hence, not subject to taxation in Italy if derived by non-residents) where the relevant securities (other than non-portfolio shares) are listed in a regulated market (pursuant to Art. 23 of the TUIR).

## 5.2 Tax Treaty reduction

Where none of the rules described above applies, to the extent that the foreign relevant fund is eligible to the benefit of a tax treaty, then Art. 13(5) of the OECD Model Convention 2017 grants exclusive right to tax to the residence State (hence, no taxation should be allowed in Italy).

***Italian sourced capital gains derived by foreign funds***

| Favourable regime | Eligible funds |
|---|---|
| **Exemption** | White-listed "Institutional investors" / publicly traded security |
| **Treaty reduction** | Funds must be a person resident in the other Contracting State |

# 6. Glossary

### Beneficial owner

Person which has the right to use and enjoy the income and which is not constrained by a contractual or legal obligation to pass on such income to another person.

### Budget law

Law to be mandatory enacted every year and containing a prevision of the State revenues and costs as well as the funds for it comply with EU obligations.

### Medium-long term loans

Loans having a maturity longer that 18 months.

### Italian Tax Authorities (“Agenzia delle Entrate”)

Agency, under control of the Ministry of Finance, which performs all the functions and tasks assigned by the law in the field of tax revenue and tax duties.

### Non-portfolio participations

Shareholdings other than portfolio participations (art. 67(1)(c) of the TUIR).

### OECD Model Convention

Tax treaty model issued and amended throughout the years by the OECD (together with a related Commentary) as a sample and guidance for treaties to be concluded by OECD Countries.

### Permanent establishment

Fixed place of business, whose domestic definition is provided for by Art. 162 of the TUIR.

### SICAF (Società di investimento a capitale fisso”)

Closed end alternative investment fund established as a joint stock company (S.p.A.) with fixed capital and a registered office located in Italy.

### SICAV (Società di investimento a capitale variabile”)

Closed end alternative investment fund established as a joint stock company (S.p.A.) with variable capital and a registered office located in Italy.

### Statement of practice

Various kinds of non-legally binding documents (either public or not published, such as rulings, circular letters etc.) through which the Italian Tax Authorities interpret tax laws.

### Tax treaty

International Convention concluded between two States for the avoidance of double taxation and double non-taxation in economic transactions involving them.

### TUIR (“Testo Unico delle imposte sui redditi”)

Italian Income Tax Code, enacted through Presidential Decree no. 917/1986.