EFFECT OF RULING NO. 288/2023 – ITALIAN ANTI-HYBRID RULES ATTACK THE 2020 SWISS CORPORATE TAX REFORM

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INTRODUCTION

Under the O.E.C.D./G-20 Base Erosion and Profit Shifting ("B.E.P.S.") initiative, hybrid mismatch arrangements have become a sensitive issue. This position culminated in the proposed anti-hybrid rules, *i.e.*, linking rules, to counter the double non-taxation resulting from double deductions or deductions without the inclusion of income by a counterparty.

Within the European Union ("E.U."), the Anti-Tax Avoidance Directive (E.U. Directive 2016/1164)[1] ("A.T.A.D. 1") introduced secondary legislation to ensure an effective and coordinated implementation of anti-avoidance tax measures. It establishes a minimum standard among Member States for countering tax practices that could affect the functioning of the internal market. An anti-hybrid rule is among the anti-tax avoidance measures contained in the A.T.A.D. 1. Among other things, it counters hybrid mismatches that arise in transactions touching corporate tax systems of two or more E.U. Member States.

Given the limited scope of A.T.A.D. 1, the Council decided that it was necessary to strengthen the level of protection against hybrid mismatches in the internal market. Consequently, the Council enacted Anti-Tax Avoidance Directive (E.U. Directive 2017/952)[2] ("A.T.A.D. 2"), which extends the scope of A.T.A.D. to third-country situations and counters new forms of asymmetric tax outcomes caused by permanent establishment ("P.E.") mismatches, imported mismatches, reverse hybrid mismatches, tax residence mismatches, and hybrid transfers.

THE ITALIAN ANTI-HYBRID RULES

Legislative Decree no. 142/2018[3] (the "Italian A.T.A.D. Decree") transposes A.T.A.D. 1 and A.T.A.D. 2 into the Italian tax system without significant deviation. It provides rules against the erosion of the tax base of E.U. Member States and the shifting of profits, including anti-hybrids rules.[4] The Italian anti-hybrid rules apply to fiscal years beginning on or after January 1, 2020, except for the provisions targeting the reverse hybrid mismatches, which will apply to fiscal years beginning on or after January 1, 2022.

1 Council Directive (E.U.) 2016/1164 of July 12, 2016.

2 Council Directive (E.U.) 2017/952 of May 29, 2017.

3 Legislative Decree no. 142 of November 29, 2018.

4 Reference is made to Articles from 6 to 11 of the Italian ATAD Decree.

Qualifying Taxpayers

The Italian anti-hybrid rules apply to all persons subject to Italian corporate income tax ("*Imposta sul reddito delle società – IRES*,"), generally imposed at the rate of 24%, including Italian P.E.'s of nonresident companies, partnerships treated as fiscally transparent under the Italian tax law, and individual entrepreneurs.

Scope

Mismatches involving taxpayers considered to be controlling or controlled enterprises located in different jurisdictions or arising in the context of a structured arrangement between two independent enterprises, wherever located, are covered by the Italian anti-hybrid rules. The notion of control[5] and structured arrangement[6] is in line with the definitions of under A.T.A.D. 1 and A.T.A.D. 2.

The Explanatory Note to the Italian A.T.A.D. Decree is aligned with point 28 of the Preamble to A.T.A.D. 2, and mirrors the explanations and examples included in the 2015[7] and 2017[8] O.E.C.D. B.E.P.S. Report on Action 2 – Hybrid Mismatch, which is a primary source of interpretation.

The purpose of the Italian anti-hybrid rules is to prevent double nontaxation by eliminating the tax advantages of mismatches and to put an end to (i) multiple deductions for a single expense, (ii) deductions in one country without corresponding taxation in another, and (iii) the generation of multiple foreign tax credits for the amount of a single foreign tax paid.

In particular, the Italian anti-hybrid rules target payments under a hybrid mismatch arrangement that give rise to one of the following three outcomes:

- **Deduction and non-inclusion mismatch ("D/N.I.").** This arises when a payment results in a deduction in one jurisdiction with no corresponding inclusion in the taxable base of the recipient located in the other jurisdiction. The D/N.I. must be derived from different tax treatment (irrespective of the legal label) in the two jurisdictions involved in an instrument, payment, entity, or branch.
- **Double deduction ("D/D").** This occurs when taxpayers are entitled to a deduction in two countries for the same payment.
- **Indirect D/N.I.** This relates to payments that are deductible by the payor under the rules of the its jurisdiction of residence but are not subject to tax in the jurisdiction of residence of the payee.

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5 Reference is made to Council Directive (E.U.) 2016/1164 of July 12, 2016, Article paragraph 1, no. 4.

6 Reference is made to Council Directive (E.U.) 2017/952 of May 29, 2017, Article 1, paragraph 1, no. 2, lett. c.

7 O.E.C.D. (2015), *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2, OECD/G20 Base Erosion and Profit Shifting Project*, OECD Publishing.

8 O.E.C.D. (2017), *Neutralising the Effects of Branch Mismatch Arrangements, Action 2: Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project*, OECD Publishing.

Payments made under hybrid financial instruments and payments made by and to hybrid entities can give rise to D/N.I. Regarding D/N.I., the Italian anti-hybrid rules deny the deduction in the payer jurisdiction (the primary rule intervention). In the event the payer jurisdiction does not neutralize the mismatch, an additional defensive rule requires the payment to be included as ordinary income and taxed in the payee jurisdiction (the secondary rule intervention).

In line with point 11 of the Preamble to A.T.A.D. 1, the Explanatory Note to the Italian A.T.A.D. Decree clarifies that the Italian anti-hybrid rules are intended to address only cross-border mismatches and do not apply to mismatches arising between two taxpayers resident in Italy.

"In the event the payer jurisdiction does not neutralize the mismatch, an additional defensive rule requires the payment to be included as ordinary income and taxed in the payee jurisdiction. . ."

DEFINITION OF HYBRIDS AND MISMATCH ARRANGEMENTS

Hybrid mismatch arrangements may be divided into two broad categories, (i) hybrid instruments and (ii) hybrid entities.

Hybrid instruments may be further divided into hybrid transfers, in which persons in two or more jurisdictions claim ownership rights, and hybrid financial instruments, which are intended to allow the counterparties to take different positions as to the tax treatment of the same payment under an instrument.

In line with A.T.A.D. 2, the Italian A.T.A.D. Decree identifies different ways in which a D/N.I. (including an indirect D/N.I.) or a D/D mismatch can arise. They include the following:

- **Use of hybrid financial instruments.** A hybrid mismatch could arise where the D/N.I. is attributable to the differences in the tax treatment of the instrument or the payments made under the instrument. Examples include an instrument treated as a debt in the payer jurisdiction, but treated as equity subject to a participation exemption regime in the payee jurisdiction. Here, the payer will be entitled to a deduction for the interest payment, but the payee does not include the amounts received in taxable income.
- **Disregarded hybrid payments.** Here, a hybrid payment is deductible in the residence country of the payer, such as Italy, but is not recognized as a payment in the residence country of the payee, such as Switzerland.
- **Structures producing double deductions.** Here, a hybrid structure exists, allowing taxpayers in two countries, such as Italy and Switzerland, to claim a deduction for the same payment.
- **Reverse hybrid.** Here, there is a mismatch in identifying the taxpayer in a payment received by the entity, often a transparent partnership. In the country of residence of the entity (Italy), the payment is treated as income of its shareholder. At the same time, in the country of residence of the shareholder (Switzerland), the payment is treated as income of the entity.
- **Dual resident entities.** Here, an entity is treated as a tax resident in two different countries such as Italy and Switzerland, enabling it to obtain benefits of domestic laws or treaties of both countries.

- **Imported mismatches.** Here, a country (Italy) is denied a deduction for a payment to a resident of a second country where all of the following conditions are met:
  - The recipient is resident in a country (Switzerland) that does not have hybrid mismatch rules.
  - The payment does not itself give rise to a hybrid mismatch for the payor.
  - The taxable income of the recipient is reduced by a payment that gives rise to a hybrid mismatch or a payment made to a third person that claims the benefit of a hybrid mismatch.
- **Deemed branch payments.** Here, there is a notional payment by a taxpayer that is not calculated by reference to an actual expenditure recognized in its accounts.
- **Branch payee mismatches.** Here, (i) a taxpayer in a country (Italy), (ii) maintains a branch outside of that country (Switzerland), (iii) claims a deduction for a payment to the branch, and (iv) taxable income is not recognized by the branch.

Important Caveat

Since cross-border mismatches may also arise in other contexts (*e.g.*, the payment (i) is deductible, (ii) is characterized as interest, and (iii) is paid to a tax-exempt entity), the only types of mismatches targeted by the Italian anti-hybrid rules are those that rely on a hybrid element to produce such outcomes.

CIRCULAR LETTER NO. 2/2022 – GUIDELINES FURNISHED BY THE ITALIAN TAX AUTHORITIES

On January 26, 2022, the Italian tax authorities published Circular Letter no. 2/2022 furnishing general instructions on Italian anti-hybrid rules.[9] The most important clarifications address the following items:

Taxes Covered by the Italian Anti-Hybrid Rules

The Italian tax authorities clarified that the Italian A.T.A.D. Decree does not apply to regional tax ("*Imposta regionale sulle attività produttive – I.R.A.P.*"), generally imposed at the rate of 3.9%. Where an income tax treaty covers local taxes such as regional and municipal taxes, the Italian anti-hybrid rules only consider taxes applied at the national level.

Definition of Negative Item of Income

The Italian tax authorities clarified that this notion should be interpreted in a broad way including any item of cost correlated with a financial flow. Examples listed by the Italian tax authorities include service fees, rental fees, interest expense, and royalty payments. Interestingly, it does not include cost of goods sold.

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9 The Italian tax authorities published tax ruling no. 833/2021 on December 17, 2021, providing a preliminary set of limited clarifications on the Italian A.T.A.D. Decree on a cross-border royalty payment's scheme.

Special Tax Regimes

The Italian tax authorities affirmed that no hybrid mismatch or transaction can be challenged when the non-inclusion is caused by a tax status of financial instruments or by a tax exemption regime applicable to the beneficiary for other D/N.I. transactions or as a consequence of a special tax regime.

Nature of Anti-Hybrid Rules

The Italian tax authorities stated that the Italian anti-hybrid rules qualify as tax system rules and not as anti-avoidance rules. This means that if a hybrid mismatch and a tax evasion are challenged as a consequence of a tax audit, possible criminal violations may arise in addition to the tax consequences.

Although the Circular Letter was composed of 115 pages and various examples, the Italian tax authorities do not address all open points previously raised by stakeholders.

RULING NO. 288/2023 –UPDATED GUIDANCE ON THE ITALIAN A.T.A.D. DECREE

On April 7, 2023, the Italian tax authorities issued tax ruling no. 288/2023 (the "Ruling"), furnishing additional administrative interpretations of the Italian A.T.A.D. Decree. The facts in the Ruling involved a Swiss parent company belonging to a multinational group. The ultimate parent company of the group was a U.S. resident entity. The Italian member of the group was owned by a Swiss intermediary parent company. The Italian company acted as a limited risk distributor. It's purchases of inventory from the Swiss parent ultimately were taken into account in determining cost of goods sold ("C.O.G.S.").

Through the close of tax year 2019, the Swiss parent company computed taxable income in Switzerland under the Principal company regime. For Swiss federal tax purposes, that regime provided for the unilateral recognition in Switzerland of the existence of a deemed foreign P.E. and the attribution to the P.E. of part of the Swiss company's profits. In a nutshell, this specific regime allowed the Swiss company to reduce the base upon which taxable income was computed.

From January 1, 2020, the Principal company regime was abolished pursuant to the Swiss Corporate Tax Reform.[10] This led to a repatriation by the Swiss company of its deemed P.E. and a step-up in the adjusted cost basis of the foreign-originated goodwill acquired in the deemed repatriation. The stepped-up cost basis could be amortized over a ten-year period.[11] The amortization could be applied to offset gross profit on sales to internal or external customers or distributors.

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10 Reference is made to Federal Act on Tax Reform and AHV Financing (May 19, 2019 – Effective date January 1, 2020), and to Swiss Federal Tax Administration, Circular Letter no. 8 (November 15, 2018 – Effective date January 1, 2020), "International tax allocation for principal companies."

11 Reference is made to Article 61a, par. 1 and 2 of Swiss federal act on Federal Direct Tax of December 14, 1990, allowing taxpayers to declare for Swiss income tax purposes any hidden reserves (including any goodwill) existing at the "beginning of taxation" in Switzerland, without this giving rise to any tax liability.

In response to a question raised by an Italian company, the Italian tax authorities ruled that the amortization of the notional goodwill value in Switzerland triggered the application of the Italian anti-hybrid rules for D/N.I.[12] The Italian tax authorities explained that the step-up in adjusted cost basis for the foreign-originated goodwill and the of related amortization deductions led to a hybrid mismatch that falls within the scope of the Italian A.T.A.D. Decree.[13] The foreign-originated goodwill represented a negative item of income that triggered a deduction without a corresponding attribution of income in the country (*i.e.*, Italy) where the P.E. was deemed to exist.

Based on the above, C.O.G.S. incurred by the Italian company could not be claimed as an offset to sales when computing gross income to the extent of the amortization deduction claimed by the Swiss company for the accounting period in issue.

Effect on Other Companies

The interpretation provided with the Ruling is not binding on the applicant or other taxpayers. However, the answer given by the Italian tax authorities in tax rulings is strictly followed as guidance and scrutiny practice by tax auditors.

COMMENTS ON THE RULING

The Ruling reflects a hidden assumption that the Swiss tax regime in force from 2020 is a mere extension of the Principal company regime in force through the end of 2019. The Swiss company was unilaterally allowed to step up an amount of notional goodwill and to amortize that amount over a 10-year period. Nothing was paid by the Swiss company to acquire the goodwill. It was simply a consequence of the termination of the Principal company regime. Viewed in that light, it was analogized to old wine in new bottles.

"Whether the belief of the Italian tax authorities is correct is an open question."

Whether the belief of the Italian tax authorities is correct is an open question. The new regime in Switzerland calls for full taxation of profits from sales to the Italian subsidiary. The allowance of amortization deductions is not a special tax regime. Indeed, the Swiss treatment is aligned with rules in force in most European countries.

The rationale of the Italian A.T.A.D. Decree is clear. The Italian A.T.A.D. Decree does not (and cannot) interfere with the tax policy of a government. If Switzerland wishes to foster the Swiss companies engaging in international trades, without exploiting legislative loopholes, it is free to do so.

The Italian tax authorities seem to overrule that approach in the Ruling.

FINAL QUESTIONS

Several questions remain open by the Ruling, and depending on the answer, over-reaching may have occurred.

12 Reference is made to Article 8, par. 3 of the Italian A.T.A.D. Decree.

13 Reference is made to Article 6, par. 1, letter no. 5 of the Italian A.T.A.D. Decree.

Is the distortion caused by a hybrid mismatch or by a mere introduction of new tax legislation in Switzerland?

In Circular Letter no. 2/2022, the Italian tax authorities clarified that no hybrid mismatch/transaction can be challenged whenever the non-inclusion is caused by (i) special tax status for a financial instrument, (ii) a tax exemption regime enjoyed by the taxpayer for other D/N.I. transactions, or (iii) as a consequence of a special tax regime. Here, the new legislation was enacted through a wide ranging Swiss tax reform. Should that be sufficient to lead to the conclusion that it is something different from a special tax regime?

Moreover, according to the principle of rule of law, the Italian A.T.A.D. Decree may only tackle mismatches deriving from the hybrid instruments and arrangements expressly listed in the Italian A.T.A.D. Decree.[14]

Which provision of Italian A.T.A.D. Decree expressly addresses the transaction in the Ruling?

The Ruling does not fall in any of the hybrid mismatches identified by the Italian A.T.A.D. Decree.

In the Ruling's fact pattern, no payment or cash flow associated caused the goodwill.[15] The Italian tax authorities in fact affirmed that the notional value was recognized by the Swiss company as a consequence of the termination of the Principal company regime. This means that there is no positive item of income correlated to the supposed negative item of income – the amortization deduction generated by the deemed repatriation of goodwill to Switzerland – and that the distortion is caused only by the enactment of new legislation in Switzerland.

Nonetheless, the Italian tax authorities took a highly formalistic approach in justifying its conclusion. It stated the following:

> [I]n other words, the goodwill amortization represents, from a substantial point of view, the method to recognize for tax purposes, even after the abolition of the Principal company regime, the 'internal dealing' between the Swiss parent company and the deemed permanent establishments. This mechanism will allow to transfer negative items of income otherwise not existent.

Where can we find an "internal dealing" if the structure is grounded on a Swiss domestic tax relief?

There is no internal dealing. The Italian tax authorities purport that the termination of the Principal company regime is a notional repatriation of the deemed permanent establishments, which should be a taxable event in Switzerland. However, the amortization deductions over the 10-year period eliminate tax.

14 Reference is made to Articles 8, 9, and 10 of the Italian A.T.A.D. Decree.

15 The example of Circular Letter no. 2/2022 reported in the Ruling to support the Italian tax authorities' reconstruction of the events relates to a foreign company that purchases intangible assets to deduct the relevant annual amortization amounts. However, there is no purchase or payment in the facts involved in the Ruling.

In other words, the goodwill's amortization for the Italian tax authorities represents internal dealing between the Swiss head office and the deemed permanent establishment that results in the creation of nontaxable income.

In our view, the conclusion of the story is best described as follows:

- The Italian tax authorities seem to be offended by the old Principal company regime.
- On this basis they claimed that the old regime pollutes the new regime (and its transitional measures) in force beginning fiscal year 2020.

This approach may appear appealing, but it is not convincing.

A more detailed analysis of the technical issues shows that the arguments developed by the Ruling seems to be weak and disputable in point of fact and in point of law. Rather than a replacement or continuation of the old regime, the new regime is a "totally" distinct regime.