

ITALY INTRODUCES A PENALTY PROTECTION REGIME FOR HYBRID MISMATCHES: TRICK OR TREAT?

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INTRODUCTION

Italian anti-hybrid were enacted by Legislative Decree no. 142/2018 (the “Italian A.T.A.D. Decree”), which transposed A.T.A.D. 1 and A.T.A.D. 2 into the Italian tax system without significant deviation. It provided rules to combat base erosion and the shifting of profits. 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.

Towards the close of last year, Italy enacted legislation identifying documentation allowing taxpayers to avoid administrative penalties and criminal charges arising from aggressive use of hybrid mismatches. The new rules apply beginning with the 2023 fiscal year. It is not clear whether the new rules will set a standard that could be applied to earlier years. In principle, an Italian taxpayer with acceptable documentation covering tax years beginning in 2020 should not be subject to penalties if a tax examination by the Italian tax authorities has not been initiated by October 15, 2024.

BACKGROUND

The Italian anti-hybrid rules were addressed in detail in an article published in *Insights* last year by the authors.¹ The following discussion summarizes the rules for purposes of context.

The Italian anti-hybrid rules prevent double nontaxation by eliminating the tax advantages of mismatches, thereby putting an end to (i) claiming multiple deductions for a single expense, (ii) allowing deductions in one country without corresponding taxation in another, and (iii) generating 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 differing tax treatment in the two jurisdictions involved in an instrument, payment, entity, or branch arrangement, irrespective of the legal labels used.

¹ For more detail, see F. Di Cesare F. and D. Michalopoulos, “Effect of Ruling no. 288/2023 – Italian anti-hybrid rules attack the 2020 Swiss Corporate Tax Reform,” *Insights* Vol. 10 No. 3, (May 2023), page 28).

- **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 jurisdiction of residence but are not subject to tax in the jurisdiction of residence of the payee.

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 this respect, 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 notions of control² and structured arrangements³ are in line with the definitions under A.T.A.D. 1 and A.T.A.D. 2. Consequently, the concept of “associated enterprise” is broader than the concept under Italian laws. Consequently, material control is covered even when caused by participations voluntarily “divided” between two or more entities of the same group.

The Italian tax authorities have furnished a general set of administrative clarifications with Circular Letter 2/2022. They also published Ruling 833/2021, providing limited guidance on a cross-border royalty payments arrangement, and Ruling 288/2023 on the effects of the Italian anti-hybrid rules involving a Swiss principal and an Italian limited risk distributor. Many advisers believe that the conclusions in the second is questionable from a technical point of view.

SCOPE

Mismatches Covered

The only types of mismatches targeted by the Italian anti-hybrid rules are those that rely on a hybrid element to produce favorable outcomes for controlled parties or for participants in structured transactions. As a result, cross-border transactions that do not involve a hybrid element are not covered. An example is a transaction in which the payment is (i) deductible, (ii) characterized as interest, and (iii) paid to a tax-exempt entity).

In addition, distortions caused by (a) domestic law or (b) the availability of preferred tax regimes, or (c) under tax rulings in certain tax jurisdictions should not be subject

² Reference is made to Council Directive (EU) 2016/1164 of July 12, 2016, Article 2, paragraph 1, no. 4.

³ Reference is made to Council Directive (EU) 2017/952 of May 29, 2017, Article 1, paragraph 1, no. 2, lett. c.

to challenge under the Italian anti-hybrid rules. Nonetheless, the negative conclusion reached by the Italian tax authorities in Ruling 288/2023 cannot be underestimated.

Taxes Covered

The Italian anti-hybrid rules apply to all persons subject to Italian corporate income tax (“*Imposta sul reddito delle società – I.R.E.S.*”). Generally, the tax is imposed at the rate of 24%. In addition to Italian corporations, taxpayers include Italian permanent establishments of nonresident companies, partnerships treated as fiscally transparent under the Italian tax law, and individual entrepreneurs.

Regional tax (“*Imposta regionale sulle attività produttive – I.R.A.P.*”) is 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 or highest level (e.g., at the federal level in Switzerland).

Nature of Anti-Hybrid Rules

The Italian anti-hybrid rules qualify as tax system rules and not as anti-avoidance rules. This means that, if a hybrid mismatch is identified in the course of a tax audit, the Italian tax authorities can impose administrative penalties on the I.R.E.S. tax return ranging from 90% to 180% of the increased I.R.E.S. assessed.⁴ On the other hand, if the adjustment is characterized as tax evasion, and if the relevant thresholds⁵ are met, the matter could be referred to the Public Prosecutor for prosecution of potential criminal violations.

PENALTY PROTECTION

The Hybrid Dossier

Article 61 of Legislative Decree no. 209/2023,⁶ implemented international tax reform in Italy. It introduces⁷ penalty protection for asserted violations of the anti-hybrid rules. The protection is similar to the regime in place for more than a decade involving underpayments of tax arising from intercompany transactions that are carried on by related parties at values that are not arm’s length.

The new penalty protection regime provides that administrative penalties will not be imposed if the taxpayer timely prepare a specific set of qualified documentation (so-called “hybrid dossier”) illustrating the internal analyses that was performed at group level justifying the cross-border transactions from the perspective of the anti-hybrid rules.

⁴ Reference is made to Article 1, paragraph 2 of Legislative Decree no. 471 of December 18, 1997.

⁵ Reference is made to Article 4 of Legislative Decree no. 74 of March 10, 2000.

⁶ Legislative Decree no. 209 of December 27, 2023, effective from December 29, 2023.

⁷ Reference is made to the newly introduced paragraph 6-bis in Article 1 of Legislative Decree no. 471 of December 18, 1997



The Reason Behind the Policy

The policy behind the penalty protection is the promotion of timely and complete disclosure by taxpayers. Protection applies when Italian tax authorities are provided with a preventive disclosure of any potential hybrid mismatch. Disclosure is preventive when it provides

- an accurate description of the material terms of the transaction,
- the relevant laws in Italy and the other country involved, and
- the rationale behind the assertion that anti-hybrid are inapplicable.

Content and Format

As a rule, the content and the format of the hybrid dossier should have been detailed in a decree of the Italian Ministry of Economy and Finance to be issued within 60 days from the date of entry into force of Legislative Decree no. 209/2023. Considering that the new legislation entered into force on December 29, 2023, the term expired on February 28, 2024. Because the 60-day rule was missed by the Ministry of Finance, taxpayers have at least 6 months from the date of publication to prepare the hybrid dossier.

In the absence of regulations of the Ministry of Economy and Finance, it is anticipated that some form of guidance will be issued more or less stating the following:

- The hybrid dossier must be prepared and electronically locked and signed with a time stamp by the legal representative of the Italian entity prior to the submission of the I.R.E.S. tax return for fiscal year 2023.
- The availability of the hybrid dossier must be communicated to the Italian tax authorities in the same I.R.E.S. tax return, perhaps by checking a box in the return as in the case of the transfer pricing documentation.
- The hybrid dossier must be made available to the Italian tax authorities in the event of a tax audit.

Fiscal Years Covered by the Penalty Protection

The first fiscal year that can be covered by the penalty protection regime is fiscal year 2023. Subsequent fiscal years will also be included in scope.

There is the possibility to backdate the effects of the penalty protection regime to fiscal years from 2020 to 2022 provided that – at the time of the submission of the I.R.E.S. tax return for fiscal year 2023 – currently October 15, 2024 – the Italian tax authorities have not started a tax audit, investigation activities, or other similar actions for those fiscal years.

COMMENTS AND TAKEAWAYS

Tax Benefit

The introduction of the new penalty protection regime for hybrid mismatches represents a significant forward step in Italy for promoting cooperation between taxpayers and Italian tax authorities. While the hybrid dossier may be viewed as an

additional compliance burden, its preparation generates significant advantages both in terms of penalty elimination and tax risk management.

Nonetheless, the legal framework is incomplete as of the date of publication of this article. The publication of the implementing rules by the Ministry of Economy and Finance has not yet taken place. This adversely affects taxpayers intending to extend coverage of the hybrid dossier to cover fiscal years from in the 2020-2023 period.

Finally, the due date remains October 15, 2024, which is not far away, if not extended.

Is This Big News?

The introduction of the hybrid dossier is not a “pure novelty,” considering that the new legislation copies the previous guidance furnished by the Italian tax authorities with Circular Letter no. 2/2022. There, the authorities recognized the preparation of ad hoc documentation represents:

*** a good practice to manage the relevant tax risk for taxpayers that perform, before the submission of the tax return, appropriate investigations on any potential case of hybrid mismatches also requesting the assistance of associated enterprises, in order to prepare appropriate documentation to be used as evidence.

Nonetheless, if the dossier is not big news, it is definitely the formalization of a good practice.

Groupwork

The preparation of the hybrid dossier is expected to require coordination between various departments of all the companies of the group involved in the “hybrid” transactions. Information regarding relevant intercompany operations will need to be gathered and presented according to a uniform standard.

It will be essential to map the transactions originating in covered fiscal years that may have potential impact on the determination of the taxable base in all countries involved. Relevant information should cover items such as tax loss carryforwards, depreciation, excess interest expense, and other similar items.

Limitations for Prior Fiscal Years

Article 61 of Legislative Decree no. 209/2023 expressly states at paragraph 3 as follows:

With regard to precedent fiscal years *** [the penalty protection regime applies] if the documentation listed under paragraph 6-bis of Article 1 of Legislative decree no. 471/1997 is prepared, with certified date, within the term for the submission of the IRES tax return *** [for fiscal year 2023] and if the violation has not been already ascertained and anyhow provided that no accesses, inspections, tax audit or any other administrative activities of assessment have been started ***.

This means that the effect of the hybrid dossier for covered fiscal is precluded where the Italian tax authorities have already initiated a tax audit, investigation activities,

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or similar actions. This means that the deadline for Italian tax authorities to begin an examination of the years 2020-2022 is the date for the submission of the I.R.E.S. tax return for fiscal year 2023, currently set at October 15, 2024.

The formulation of the statute is composite and complicated. While audit activities have been specifically identified in the law, the law does not specify the contents of other administrative activities that may adversely affect the years in the 2020-20233 time period. Is that intentional or an oversight?

The point is crucial. The Italian tax authorities have already begun to notify targeted taxpayers with questionnaires pursuant to Art. 32 of Presidential Decree no. 600/1973⁸ requesting explanatory information and supporting documentation for items such as tax calculations, copies of financial statements and trial balances, and accounting registrations in connection with the possible existence of hybrid mismatches for years in the 2020-2022 fiscal period. This begs the following question: Does a questionnaire represent an administrative activity of assessment?

The available guidance is silent in this respect, and the precedent administrative clarifications on similar tax rules is contradictory in some cases, unsatisfactory in others, and negative in still others.⁹

A prudent interpretation suggests that the questionnaires may limit the effect of the penalty protection for the years in the 2020-2022 period. On the other hand, it is also logical that the notification of these of requests should not jeopardize the benefit from the penalty protection regime in case of duly and timely preparation of the hybrid dossier. In essence, the devil is in the details, and it cannot be excluded that, lacking official stance, different interpretations may be given by the local offices of the Italian tax authorities in charge of the audits.

Criminal Shield

The wording of the relevant legislation does not automatically extend the penalty protection regime to criminal infringements. Nonetheless, considering that the complete and truthful description of the transactions in the hybrid dossier and the voluntary disclosure in the tax return constitute undoubted material evidence of the taxpayer's intent to cooperate, it seems reasonable to expect that criminal liability should be "off the table."

⁸ Presidential Decree no. 600 of September 29, 1973.

⁹ See, for example, Circular Letter no. 180/1998 commenting on old tax rules with similar wording.