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TaxUpdate

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Reserves formed with tax exempt income – Option for a substitute tax – Availability for distributions

Overview

Finance bill 2005 (law 311 of 2004) has introduced the option for Italian-resident companies to apply a (reduced) substitute tax on specific "tax-suspended" reserves and provisions recorded in financial statements.

Through such option the said reserves, formed with (i) income of preceding years not subjected to income taxation or (ii) low-taxed asset revaluation provisions, will be assimilated to any other income reserves and fully distributable as dividends following specific procedures.

Option for the substitute tax

Eligible reserves and provisions must be contained in the equity section of financial statements closed in the FY running at December 31st, 2004, regardless if they have been previously utilized to rise the company's share capital.

The rate of the substitute tax amounts to:

- **10%** of the reserves and provisions having a "suspended" tax regime (i.e. taxable in case of distribution or other taxable utilizations);
- **4%** of the reserves arising from specific revaluation provisions provided by Law 408/90, 413/91 and 342/00, in order to update accounting values of fixed assets through the payment of a substitute tax.

Reserves posted for anticipated depreciations are excluded from this option.

The option may be exercised with respect of all or part of the above reserves.

Liquidation of the substitute tax

The 4% or 10% substitute tax, as the case may be, must be liquidated in the tax return to be filed in respect of the FY running at December 31st, 2004 and must be paid in only one solution (without the possibility to benefit by installments) along with the balance of corporate tax due for the same FY.

In practical terms, for companies closing their accounts on December 31st 2004, the substitute tax must be paid by June 20th, 2005 (or by July 20th, 2005 if the financial statements are approved within the allowed 6-month delayed term).

The substitute tax is not a deductible expense for corporate income tax purposes.

For accounting purposes, the tax may be normally charged to the profit and loss account or, alternatively, directly booked in reduction of the share capital, reserves or provisions resulting from the financial statements.

Effects of the substitute tax

As a general rule, a distribution of a reserve formed with tax exempt income is ordinarily included in the taxable income of the distributing company and is subject to 33% corporate income tax (IRES) and 4,25% local income tax (IRAP). The same happens with the utilization of the said reserves for purposes other than those allowed by the specific relief law (usually, the utilization for coverage of losses does not trigger any taxation).

The 4% or 10% tax voluntarily paid by the company substitutes the above corporate and IRAP income taxes and gives full fiscal relevance to the mentioned reserves.

In practical terms, the substitute tax grants the possibility to distribute the "tax-suspended reserves" (formed with previous years exempt profits or low-taxed asset revaluation) or to otherwise freely dispose of them, without the burdensome fiscal consequences normally associated to those operations.

Subsequent distribution

The above reserves can then be distributed to the shareholders as dividends. Revaluation reserves subject to the 4% substitute tax are distributable according to the same procedure provided for the share capital reduction.

Since from 2004 Italy has adopted an exemption system (as opposed to the previous imputation system), this means that the said reserves may now be distributed :

- with a reduced taxation (4% or 10%) for the distributing company and
- a 95% exemption for the resident corporate shareholder (a full exemption is provided in case of a Fiscal Unit).

The option may also be interesting for foreign shareholders wishing to repatriate such reserves with a limited tax burden.

The distribution will be then tax exempt under the parent/subsidiary Directive or otherwise subject to the ordinary or treaty w/h tax applicable on dividends.

In planning a distribution of reserves from an Italian company attention must be devoted to the respect of the new thin capitalisation rules introduced in Italy starting from 2004 and to the related debt equity ratio of 4 to 1.

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