

## Measures to prevent under-capitalisation: thin capitalisation rule and pro-rata rules

From 1 January 2004 thin capitalisation rule and pro-rata rules have been introduced in the Italian tax system.

### THIN CAPITALIZATION RULES

Thin capitalisation rules aim to prevent the use of under-capitalisation for tax purposes: more specifically, they fix a threshold for the loans granted or guaranteed by all the qualified shareholders and related parties and limits deductibility for consideration on loans exceeding such threshold.

During the fiscal year, if the ratio between:

- the average level of financing (consisting of loans, money on deposit and any other form of financial relationship) granted or guaranteed by the qualified shareholder and related parties, and
- the net equity resulting from the financial statement of the previous accounting period

exceeds a ratio of **4:1** (**5:1** for 2004 only), interest on the excess indebtedness is not deductible for income tax purposes.

Thin capitalisation rules do not apply in the following cases:

- if the total loans granted and guaranteed by the qualified shareholder or related parties do not exceed four times the accounting net equity, as recorded in the financial statement for the previous year, inclusive of any undistributed profits for the same year and adjusted accordingly;
- if the borrower proves that the loans are granted/guaranteed by the qualified shareholder and/or related parties on the basis of its own credit capacity and consequently that under the same circumstances such loans would also be granted by third independent parties on the basis of the borrower's equity capacity.

Loans guaranteed by the shareholder or related parties may take the form of secured loans, third party guarantees and de facto guarantees, which may also be granted thereby in the form of actions and legal transactions that, while not officially classified as guarantees, produce the same financial effect.

A shareholder is considered **qualified** when:

- it directly or indirectly **controls** the financed party;
- it has at least a 25% interest in the **share capital** of the financed party, also taking into account the shareholdings of related parties.

**Related** parties are defined as companies that are controlled by the qualified shareholder on the basis of article 2359 of the Civil Code.

The net equity to be taken into account in order to determine the debt/equity ratio in respect of the qualified shareholder and related parties is the accounting net equity appearing in the financial statement for the previous year inclusive of the year's undistributed profits,:

- less the subscribed capital not yet paid;
- less the book value of own shares;
- plus losses, if the net equity has not been built up through undistributed profits or contributions within the second financial period following the loss;
- less the lowest of the book value and the accounting net value in controlled and related companies resident in Italy.

Please note that some amendments to the thin capitalization rules are expected to be introduced by the 2005 financial bill.

### PRO-RATA

The so-called "*pro rata*" introduces a further restriction on interest deduction in relation to shares that benefit from the participation exemption rules.

More specifically, if at the end of the fiscal year the value of the investments to which the participation exemption rule applies exceeds the accounting net equity, interest expenses, less interest income, remaining after the application of thin capitalisation rules, are not deductible up to the ratio between:

- the excess value of investments benefiting by the participation exemption over the accounting net equity, and
- the difference between the total assets and net equity, less commercial debts.

Similarly to thin capitalization rules, the accounting net equity is determined:

- taking into account the profit for the accounting year;
- reduced by subscribed but unpaid capital;
- increased by losses, if the net equity has not been built up through undistributed profits or contributions executed within the second financial period following the loss.

These rules do not apply when the exempt participations are held in a company that opts for tax consolidation or when the exempt participations are held in a company whose income has been imputed to the shareholders under the flow-through system (tax transparency). However, if the participation is sold within three years after the date on which it was purchased, the taxable income for the tax period in which it is sold is increased by an amount that is equal to interest expenses that would not have been deductible if said participations had contributed to form the ratio.



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