



September 2007

ITALY

TRANSACTIONS WITH ENTITIES LOCATED IN TAX HAVENS: AMENDMENTS TO THE LEGAL REQUIREMENTS FOR DEDUCTIBILITY OF EXPENSES

Legal requirements for the deductibility of expenses prior to the Finance Act 2007:

Under Art. 110, paragraph 10, of the Italian Income Tax Act (hereinafter, ITA) costs and other expenses deriving from transactions with entities located in tax havens are in principle not deductible for Italian tax purposes. However, paragraph 11 of the same Article allows Italian companies to deduct such costs provided that:

- (i) they prove that said foreign entities carry out a real business activity or, alternatively, that the relevant transactions have a sound business purpose and have actually taken place (i.e. business purpose test); and
- (ii) they indicate the amount of such costs also in a separate section of the corporate tax return (last sentence of paragraph 11).

Accordingly, the Italian tax authorities have disallowed the deduction of such costs when they were not separately and specifically indicated as described above. Moreover, the Italian tax authorities have also denied taxpayers the possibility to amend their corporate tax return (i.e. filling out also the specific section) when a tax assessment procedure has been initiated against them.

The Presidential Decree No. 322/1998 (Guidelines for filing Income Tax Returns Act) generally allows -i.e. without mentioning whether or not a tax assessment procedure has started- taxpayers to complete the information indicated in their tax return with a supplementary tax return to be filed within a prescribed term. On these grounds, the tax authorities' strict interpretation of Art. 110, paragraph 11, of the ITA has been criticized by many Italian scholars.

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Legal requirements for the deductibility of expenses as amended by the Finance Act 2007:

The Finance Act 2007 (viz. Art. 1, paragraphs 301, 302 and 303) has brought in the following amendments:

- (i) A sentence stating that “the amount of costs and other expenses deriving from transactions with entities located in tax havens shall be indicated separately in the corporate tax return” has been included in Art. 110, paragraph 11, of the ITA.
- (ii) At the same time, the last sentence of paragraph 11 has been repealed. Therefore, the separate and specific indication of the amount of costs is, as such, no longer a requirement for the deduction.
- (ii) However, the failure to separately indicate such costs is now punished with a tax penalty equal to 10% of the total amount of costs and expenses omitted. The tax penalty may vary within 500 and 50,000 Euro.
- (iii) The tax penalty described above will also apply to failures to separately indicate said costs that have occurred before the entry into force of the Finance Act 2007 (i.e. January 1, 2007). In this case, however, the tax penalty may not be higher than 2,065.83 Euro.

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