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tax + legal newsflash

Important changes in law and regulations

Italy issues draft circular on hybrid mismatch arrangements

In brief

The Italian Tax Authorities (ITA) launched, on October 18, a public consultation on the draft interpretative Circular Letter (the 'Draft Circular'), which, at 111 pages, covers the application of the hybrid mismatch arrangements rules (the 'Hybrid Rules') as governed by Legislative Decree 142/2018 (the 'ATAD Decree') that implements the ATAD Directives through domestic Italian legislation.

Action item: *The public consultation is an opportunity to participate in the legislative process and share operational and technical views on this complex and innovative legislation. Interested parties are invited to provide comments by November 19, 2021.*

In detail

The Hybrid Rules are complex both from a technical and compliance point of view as they involve cross-border scenarios that - even if they had specific and identifiable in vitro normative requirements (i.e., a 'deduction, no inclusion' (D/NI) or 'double deduction' (DD) effect that is attributable to a hybrid element - a difference in tax characterization - and a subjective scope) - can be difficult in practice to detect (quantify) and comply with.

In sum, the Hybrid Rules seek to deny for tax purposes the deductibility of negative items of income (otherwise deductible) or, alternatively, to force the inclusion of positive items of income in the taxable base (otherwise not included or recognized) to the extent that:

- there is a cross-border mismatch (a 'D/NI' or 'DD');

- such mismatch involves related parties (including entities acting in concert) or parties under a structured arrangement (scope); and
- the mismatch is attributable to the different tax qualification of a financial instrument (or related items of income, including hybrid transfers), hybrid entity (direct or reverse), or permanent establishment (including incoherent profit attribution).

Observation: Considering the complexity of the Hybrid Rules, the effectiveness of the ATAD Decree since January 1, 2020, and the November 30, 2021, due date by which Italian calendar-year taxpayers must submit their FY 2020 tax returns, the clarifications provided by the Draft Circular are particularly relevant since, if a 'hybrid mismatch' is detected, taxpayers need in principle to 'remove' it within the 2020 tax return through an upward tax adjustment.

The Draft Circular provides extensive guidelines for applying the Hybrid Rules to a long list of hybrid mismatches. It also addresses in detail a number of complex rules that have no precedent under Italian tax law.

The Hybrid Rules do not include specific anti-abuse rules. Therefore, based on the clarification provided by the Draft Circular, (i) application of the Hybrid Rules cannot be waived through a specific ruling request (as is typically the case for specific anti-abuse rules) and (ii) if they find a 'hybrid mismatch', the tax auditors may recommend to the criminal prosecutor a criminal tax violation, as set forth by decree no. 74/2000.

Observation: From a risk management point of view, the Draft Circular underlines the importance of taxpayers having proper documentation to support their 'hybrid mismatch' analysis. Such documentation must be presented during a tax examination if requested. In that regard, the Draft Circular references art. 32(5) of the Presidential Assessment Decree no. 600/73 which, broadly speaking, prevents the taxpayer from relying on any documentation during the tax assessment procedure or in subsequent tax litigation that, once requested during a tax examination, has not been timely provided.

The Draft Circular provides the following clarifications:

- The relevance as a deduction of a broad range of negative items of income - e.g., a deduction in a D/NI scenario can include cost of goods sold, amortization, and depreciation.
- A grandfathering rule limited to transactions carried out before the fiscal year that includes December 31, 2016.
- The definition of dual inclusion income as any amount which is either (i) included in both jurisdictions where the mismatch outcome has arisen or (i) included in one jurisdiction and not deducted in the other.
- The application of reverse hybrid entity rules without any (i) investors threshold and (ii) limitation based on the qualification of the funds.
- The possibility of relying on distributions made by a reverse hybrid to its own taxable investors in order to remedy the D/NI mismatch.

- The definition of the conditions under which a CFC rule might be considered as an alternative form of 'inclusion' or 'dual inclusion income' suitable to remove D/NI or DD effects.
- The application of the Hybrid Rules to Italian CFC rules (i.e, to perform the ETR test and calculate the CFC income taxable in the Italian parent's hands).
- The non applicability of the Hybrid Rules for Regional tax purposes.
- The nonabusive nature per se of restructuring transactions where the taxpayer aims to actually remove hybridity.
- The application of anti-hybrid imported mismatch rules to arrangements where the payee is in an EU Member State.
- The applicability of the Hybrid Rules when a taxpayer decides to neutralize the mismatch on a voluntary basis, not following any anti-hybrid rule in the taxpayer's jurisdiction.

The takeaway

Considering that the Hybrid Rules are aimed at targeting cross-border scenarios, both Italian and foreign multinationals should consider their potential impact as currently interpreted by the Draft Circular. Taxpayers also should proactively analyze their position for Italian tax purposes and develop proper documentation of the analysis in case of an audit.

Any questions?

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