ABSTRACT

“Non-Operating Companies”: Taxation without income?

In Italy, the tax regime of the so-called “non-operating companies” was instituted in 1994 (Section 30 of law n. 724 of 1994).

The aim of the law regarding convenient companies is to prevent private individuals from using corporate vehicles to hold real estate only to benefit from the depreciation rules applicable to the assets and the deduction of VAT paid on the services acquired (i.e. maintenance services).

That discipline was modified several times in the following years:

- Firstly by article n. 27 of the LD n. 41 issued on 23rd February 1995
- Then by article n. 2 of the LD n. 437, issued on 8th August 1996
- Finally by article n. 3, com 37 of the Law n. 662 issued the 23rd December 1996.

After a ten years pause, the non-operating companies have come to be one of the most interesting matter for the legislator. Recently the discipline of the tax regime has been modified again several times in a few months (Finance Act 2008).

Since 1st January 2007, the tax regime relating to the “non operating companies" has changed significantly.

Unfortunately, even if many rules has been issued, there is no strict definition of “non-operating companies”, but a set of fixed parameters has been defined to perimeter the scope of the non-operating companies.

In 1994 the Italian legislator had already set certain minimum revenue thresholds and established that if company hadn’t reached such thresholds it would have been taxed on a figurative income.

Last amendments have raised the thresholds of these minimum revenues. Combined with the yield compression which also affected the Italian real estate market, that increase has made the non-operating companies tax regime become an issue which every investor must bear in mind for its tax planning. So when we try to identify a company as well as “non-operating” we are obliged to verify if the company under investigation meets the requirements of the “non-operating company.”

If a company is considered a “non-operating company” it shall use some estimated income coefficients to assess own “presumptive” income for direct taxes purposes. Moreover, the company has a net production value no less than the “presumptive” income above mentioned for IRAP purposes, and important limitations for the refund, compensation and assignment of annual credit for IVA purposes.

The non-operating company has to make the advance ruling in order to avoid from the taxation of “presumptive” income above mentioned.

The tax treatment of non-operating companies in Italy has undergone amendments which discouraged the use of companies for asset management in the individual shareholders' interest

This paper analyzes the purposes of “non-operating” companies tax regime and its executive mechanisms, both from a direct and indirect taxation point of view, both from a legal point of view.

Details concerning the verification and taxation of existing companies and non-operating ones are discussed.

Corporate income taxes (IRES and IRAP) under the “non-operating companies” tax regime.

The process to ascertain if a company falls within the rules of non-operating companies tax regime is based on two steps:

- first step: the comparison between the figurative income the tax authority deems appropriate through the application of certain rates (calculated on the tangible and intangible assets as recorded in the yearly financial statements) and the effective income deriving from the business activity;
- second step: in the event that the figurative income is higher than the effective one, the tax payer must apply different rates to the same tangible and intangible assets in order to calculate a presumed taxable base on which the ordinary corporate income taxes (IRES and IRAP) are applied.

These rules are applicable to companies, incorporated under the Italian company law (i.e. limited liability company limited by shares or quotas, partnerships) as well as to any Italian permanent establishment of a non-resident company.

The application of the non-operating companies tax regime does not prevent the tax payer from ignoring the application of other presumptions of profit making such as the so-called "Sector Studies" or the "Parameters" should the conditions for their application be met.

Non-resident investors making use of Italian corporate vehicles are generally subject to the non-operating. companies tax regime from the second year of activity onwards.

The non-operating companies tax regime does not apply to:

- companies with less than 50 shareholders;

- listed companies and their directly or indirectly controlling or controlled companies; and
- companies which demonstrate, within the context of a specific tax ruling procedure, that there existed objective reasons which made it unforeseeable to generate income.

Calculation of the figurative income.

Starting from 1st January 2007 the objective reasons referred above need not be necessarily of "extraordinary nature", making wider in principle the scope of application of the tax ruling procedure.

The tax ruling request for not applying such regime must be filed with the competent tax Authority which must answer to the taxpayer within 90 days from the date on which the request was filed.

The effective income deriving from the business activity must be compared to the sum of the figurative income deriving from the application of the following rates to the different assets registered in the financial statements (book value):

- 2% of the value of interests and financial credits accounted both in the current assets and in the financial assets;
- 5% of the value of the buildings classified as "Offices" (i.e. included in the cadastral category A/10);
- 4% of the value of the residential buildings acquired or stepped-up in the fiscal year or in the 2 preceding fiscal years;
- 6% of the value of property investments different from those falling within the aforementioned cadastral categories and assets listed before (as for example retail properties); and
- 15% of the value of any residual property investment.

The value of real estate investments relevant for tax purposes for the non-operating companies tax regime is defined by Article 110 of the Italian Tax Code (Presidential Decree no. 917/86 and further amendments) and is composed of:

- the gross acquisition or construction cost (i.e. before depreciations and amortizations) including ancillary expenses;
- the capitalized expenses attributable to the property, with the exclusion of general expenses and with the inclusion of interest accrued on real estate financing.

With regard to properties held through financial lease agreements, the value of the properties relevant for the non-operating companies tax regime is represented by the cost born by the leasing company or - in case such information should not be available - the aggregate value of amounts due under the lease agreement, including the redemption price.

The test is made every fiscal year only on the average value of the income, as defined above, with regard to such given fiscal year and to the two former fiscal years (if applicable).

Should the figurative income deriving from the application of the above rates per the relevant items of tangible and intangible assets exceed the effective income, the investment vehicle is subject to both corporate Income Taxes (IRES at 27,5% and IRAP at 3,9%) on the following minimum taxable base (book value):

- 1,5% of the value of both interests and financial credits;
- 3% of the value of residential buildings purchased or stepped up in the fiscal year or in two preceding fiscal years;
- 4,75% of the value of property assets such as offices or different from residential buildings; increased (valid only for IRAP purposes) by the amount of employee salaries, occasional or selfemployed assimilated fees and interest expenses;
- 12% of the value of any other property asset.

A comparison of the minimum income set by the legislator for office and retail investments (5% and 6%) with the presently offered yields on the real estate market make it evident that most of today's investments are on the edge of falling within the non-operating companies tax regime and therefore risk to pay corporate income taxes on not existing profits.

It is therefore extremely important to know that the tax payer may give evidence, within the context of a specific preventive tax ruling procedure as per article 37-bis of Presidential Decree no. 600/1973 (which has counterbalanced the increase in the applicable rates) of objective reasons resulting in the factual impossibility of earning the income deemed applicable through the application of the non-operating companies tax regime.

In case of a negative answer from the Tax Authority (or in case of the lack of an answer) it is possible to challenge the application of the hypothetical income before the competent Tax Courts.

It remains to be seen if the Tax Authorities will accept as "objective reasons" the impossibility to generate more income due to the simple fact that the market did not allow to achieve higher yields.

VAT and the “non-operating companies” tax regime.

If a company falls under the non-operating companies tax regime, that will trigger adverse consequences with regard also to the excess of input VAT such as:

- the excess of input VAT resulting from the annual VAT return cannot be refunded or compensated with other tax payments due by the entity falling within the convenient company tax regime;
- the excess of input VAT resulting from the annual VAT return cannot be assigned to third parties; and
- in case no relevant VAT transactions are carried out by the entity falling within the non-operating companies tax regime for three consecutive fiscal years for an amount higher than the thresholds calculated with the rates in question (the first set of rates described in the preceding paragraph), the excess of input VAT becomes a cost.

This latter third consequence may have a relevant impact on the overall yield calculated on the investment as the excess of input VAT may turn to be an additional cost to the investment due to the definitive loss of the right for the refund.