The substitute tax on credit facility agreements under Articles 15 and following of Presidential Decree No. 601 issued on September 29, 1973

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An amendment enacted in December 2013 now allows parties to certain credit facility agreements to opt to have a substitute apply to such transactions, as opposed to it applying by default. Such option should provide relief where the substitute tax results in a higher tax burden than the original taxes from which the transaction was exempt.

This Newsflash reflects our current understanding of the issues at the time of writing. We expect our understanding to develop over time, and the Newsflash will be updated accordingly.

Introduction and Update

An amendment enacted in December 2013 in Italy now allows parties to certain credit facility agreements to opt to apply a substitute tax. Prior to the December 2013 amendments, the substitute tax regime was automatically applied on contracts falling within the scope of the legislation. The result in some circumstances was far from being a tax relief. In particular, such treatment often resulted in a heavy tax burden for borrowers, who usually bear the burden of the tax, especially when the replaced taxes were lower.

This was in contrast with the purposes for which the substitute tax was issued. Therefore the recent amendments to the law are aimed at freeing borrowers from additional burdens, as they can opt to pay the original taxes from which they are exempt, instead of the substitute taxes, based on which results in a more beneficial tax treatment.

Background

Under Articles 15 and following of Presidential Decree no. 601/1973, the discipline of the substitute tax provides that the operations related to medium-long term credit facility agreements made by banks are exempt from the following taxes:

- registration tax;
- stamp duty;
- mortgage tax;
- cadastral tax; and
- taxes on government concessions.

Instead of such taxes, a substitute tax applies by default, whose rate is established as follows:

- **0.25 percent as the basic rate**, to be calculated on the amount of financing granted in each year or on the amount of funds given to open a credit line (e.g. revolving lines of credit);
- 0.05 percent for export finance loans;
- 0.125 percent (i.e. half the basic rate) for loans to co-operatives building social housing; or
- 2 percent for loans granted to individuals for purchasing houses, unless the house qualifies as the "first home" of the individual (in which case, the ordinary 0.25% rate applies).

The substitute tax is applied on a one-time basis upon loan origination, and the taxable base is the amount that the lender provides or commits to provide as financing.

According to the law, medium-long term operations are those contracts with a duration of **more than eighteen months** (meaning that a duration of exactly 18 months falls short of the requirement). This duration is contractual, rather than actual, and in case the actual might be shorter, the eligibility of the transaction depends on the technicalities of the early termination provision in the contract.

Territoriality rule

When originally enacted, the substitute tax was applied when the following three conditions were met:

1) the existence of a "medium-long term loan," meaning a loan that was contractually granted for a duration of more than eighteen months;
2) the loan was granted by a banking entity; and
3) the formation of the contract by which the loan was granted was in the Italian territory.

Among the conditions listed above, the condition referred to in point 3 (the territoriality), has resulted in many interpretations by the Italian Tax Authority over the years.

- First, in 2000, the Tax Authority provided that the "financing operations carried out by banks outside the Italian territory were not liable to the substitute tax but to the ones in force in the foreign country."
- Then, in 2008, the same Tax Authority, while confirming the interpretation provided above, envisaged "the possibility of an hypothetical elusive practice," particularly with reference to cases where the signing of the loan outside Italy was put in place in order to avoid the substitute tax, even if the contract was intended to produce effects in Italy.
- More recently in 2013, the Tax Authority, overcoming the position expressed above, and in accordance with the orientation of the Supreme Court, noted that the place of signing the contract does not seem likely to fall within the concept of "abuse of rights."

> However, the Tax Authority focused on the notion of contract conclusion stating that the conclusion of a contract can be validly achieved even through term sheets, which can show that the "formation of the consensus on the essential elements of the loan agreement" happened in Italy.

Emphasizing the latter opinion concerning the time of conclusion of the loan agreement, and considering other factors deemed relevant (such as the drafting of the contract in Italy or the choice of Italian law as the applicable one), the tax Authorities started investigations of several banks on the substitute tax application.

The investigations carried out by the Tax Authorities were focused on monitoring the substitute tax application both for Italian and foreign operators having permanent establishments in Italy. Under the Italian Tax Authority interpretation, the substitute tax should have also been applied to those contracts that, even if signed abroad, could still be considered as concluded in Italy since the consensus regarding their essential elements was reached therein.

Following the December 2013 amendments, this issue should be settled from the outset.

December 2013 amendments to substitute tax

Prior to the December 2013 amendments, there was indeed a discrepancy between the expressed purpose originally pursued and the higher tax burden generally resulting in practice. The Legislator has now provided the opportunity for taxpayers to elect to apply the substitute tax, only on optional basis, thereby preserving its original nature of providing tax relief.

Article 17(1) of Presidential Decree no. 601/1973 now provides that:

> *The entity carrying out the operations indicated in the Articles 15 and 16, following a specific option, may pay a substitute tax, instead of registration tax, stamp tax, mortgage tax, cadastral taxes and taxes on government concession. The option shall be exercised in writing in the credit facility agreement.*

The application of the substitute tax, in lieu of taxes replaced, is now possible only by election and can be exercised only in written form. The law does not specify whether the exercise of the option is up to the bank (lender) or to the beneficiary of the loan (borrower). The taxable entity is the bank, on which lies the responsibility to declare and pay the tax. However, the tax is generally contractually charged to the borrower who ultimately ends up bearing the burden of the tax. Thus, the possibility to now opt for the substitute tax is a provision in favor of the borrower, but the evaluation on whether to opt to apply the substitute tax has to be made on a case by case basis, comparing the total amount that should be paid applying the ordinary taxes rather than the substitute tax.

The evaluation should also take into account that the non-application of the ordinary taxes could result in a disadvantageous choice where, for example, a contract is signed through correspondence (and no taxes are applied) and subsequently the registration is needed because the "case of use" occurs (in this case, the application of ordinary taxes could be higher than the substitute tax).

The extension of the substitute tax to structured financing transactions

The possibility to opt for the substitute tax in lieu of the replaced taxes has been extended also to the guarantees of any kind provided with reference to structured finance transactions. In particular, the new Article 20-bis of Presidential Decree no. 601/1973 named "Transactions of structured financing" has been added.

According to the new provision, a party to the transaction is also given the possibility to opt for the application of the substitute tax with reference to guarantees in relation to financing transactions carried out through the issuance of certain bonds or securities.

As clearly required by law, the option must be exercised and result in the bonds or securities issuance resolution, which must be made in a public act. In these cases, the option may be exercised even if the loan is granted by a non-bank entity, since the new provision specifies that the bonds or similar securities issued can be underwritten by anyone.

The new provision seems designed to extend the possibility to opt for the application of the substitute tax exclusively with reference to these cases where specific real or personal guarantees are implemented through the issuance of bonds or similar securities. The option does not seem to extend to the issuances of bonds or similar securities for which no specific guarantee is given, and in such cases, only the ordinary taxes will be applicable.

As discussed above, Article 20-bis also does not specify who has the right to opt for the substitute tax in the contract. However, it does state that both the entities that have issued the bonds and the financial intermediaries in charge of the promotion and placement of the bonds are jointly liable for the payment of the substitute tax. It further specifics that the tax is solely payable by the companies issuing the bonds or similar securities in case there is no intervention of the above mentioned intermediaries.

Further amendments

Subsequent to the December 2013 amendments, an additional amendment was made in 2014 which enlarged the scope of application of the provision to apply the substitute tax:

- the scope now also includes the transfer of credits / contracts originally granted under the substitute tax regime, as well as the transfer of any related guarantee. This should make life easier for the ex-post syndication of the relevant loans;

- while so far only banks could grant loans under the substitute tax regime, now also EU insurance companies and EU mutual funds qualify as eligible lenders.

Furthermore, the above amendment did not target substitute tax only. It also provided that no withholding tax applies to interest on medium-long term loans granted by EU banks, insurance companies, and unleveraged funds. EU banks who had previously been using their Italian branches to avoid withholding tax are now considering directly granting loans to Italian companies. As a result, it is much more relevant for certain banks to understand the substitute tax regime in Italy.

What this means in practice

Given that the December 2013 amendments now provide banks with the option of applying the substitute tax, instead of it applying by default, there is less of a need to restructure applicable credit facility agreements to remove them from the scope of application of the substitute tax. For example, where banks may previously have structured contracts to be signed outside of Italy to fall outside the scope of the substitute tax regime, now, if the application of the substitute tax is less beneficial and results in a higher tax burden than the original taxes from which they were exempt, such banks can simply opt to pay the original taxes. Thus, this amendment provides relief for the parties to applicable credit facility agreements to take advantage of the intended purpose of the substitute tax regime and apply whichever tax results a more beneficial tax burden.

PwC contacts

If you would like further advice or information in relation to the issues outlined above, please call your local PwC contact or any of the individuals listed below:

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