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BEPS Action 2: Italian ACE Regime

In this article, the author comments on the Italian Allowance for Corporate Equity (ACE) regime, pursuant to which, subject to certain conditions, a portion of a company's global income might benefit from a discount in respect of the payment of Italian corporate income tax and business regional tax. In particular, the author determines that ACE is not a hybrid mismatch instrument and discusses the extent to which it might lead to double non-taxation in light of BEPS Action 2.

1. Introduction

The purpose of Action 2 of the OECD BEPS Framework is to fight the effects of hybrid mismatch arrangements. Hybrid mismatch arrangements are used in aggressive tax planning to exploit differences in the tax treatment of an entity or instrument under the laws of two or more tax jurisdictions to achieve double non-taxation, including long-term tax deferral.

Since the announcement of the Action 2 recommendations, a number of countries that are part of the Inclusive Framework have adopted rules to address a comprehensive range of hybrid and branch mismatches. In 2019, the US Treasury issued regulations clarifying the application of hybrid mismatch rules introduced under the Tax Cuts and Job Act and the EU Member States adopted the Amending Directive to the 2016 Anti-Tax Avoidance Directive (2017/952) (ATAD 2),[1] which requires hybrid and branch mismatch rules to be effective in Member States no later than the beginning of 2020.

Based on section 267A of the US tax regulations, anytime an amount is paid by a US company, as a royalty or interest, to a foreign company benefiting from a special regime, in circumstances in which such income would not effectively be subject to taxation in the beneficiary's foreign jurisdiction, the tax deductibility of the aforementioned payment can be disregarded in the United States in order to avoid double non-taxation.

On the Italian side, the Allowance for Corporate Equity (*Aiuto alla Crescita Economica*, ACE) is a notional interest deduction regime pursuant to which, provided several requirements are met, a portion of a company's global income might benefit from a discount in respect of the payment of Italian corporate income tax (also known as *Imposta sul reddito delle società*, IRES)[2] and business regional tax (also known as *Imposta regionale sulle attività produttive*, IRAP).[3]

The observations that follow are intended to investigate ACE and its practical functioning, including through some examples, to determine the extent to which ACE might lead to the phenomenon of double non-taxation. In doing so, the author reviews the Italian legislation, as well as its practical application, in the context of the provisions of Action 2,[4] which many countries have implemented to combat misalignments.

2. Italian Legislation

2.1. *Ratio legis*

The ACE regime was introduced by way of Legislative Decree 201/2011,[5] as amended and converted by Law 214/2011,[6] and is regulated by the latest guidelines contained in a Ministerial Decree of 3 August 2017,[7] issued by the Minister of Economy and Finance.

The aim pursued by the Italian legislator in introducing the ACE rule was to:
– incentivize the capitalization of Italian taxpayers carrying out business activities;[8] and
– reduce the disparity in tax treatment existing between companies that finance themselves through debt capital (and have the right to deduct interest paid from their taxable income) and those companies financing themselves through retained earnings and capital risk contributions (for which no specific deduction measures were foreseen).

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1. Council Directive (EU) 2017/952 of 29 May 2017 amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries, OJ L 144/1 (7 June 2017), Primary Sources IBFD [hereinafter ATAD 2].
2. IRES is imposed under Title II of IT: Income Tax Consolidation Act [*Testo Unico delle Imposte sui Redditi*, TUIR], Presidential Decree No. 917/1986, Primary Sources IBFD.
3. IRAP is imposed under IT: Legislative Decree 446/1997, Official Gazette no. 298 (23 Dec. 1997) – ordinary supplement.
4. OECD/G20, *Neutralising the Effects of Hybrid Mismatch Arrangements – Action 2: 2015 Final Report* (OECD 2015), Primary Sources IBFD.
5. IT: Legislative Decree 201/2011, Official Gazette no. 284 (6 Dec. 2011) – ordinary supplement.
6. IT: Law 214/2011, Official Gazette no. 300 (27 Dec. 2011) – ordinary supplement.
7. IT: Ministerial Decree of 3 August 2017, Official Gazette no. 187 (11 Aug. 2017) – ordinary supplement.
8. In its report *Studi Economici dell'OCSE – ITALIA – Febbraio 2015 – Overview*, available at hiips://www oecd org/economy/surveys/Overview%20 Italy_2015_ITA.pdf, the OECD provides details on the reform programme implemented by Italy in order to face the economic stagnation experienced by the country. Among the recommendations provided by the OECD, there is a need to stick to the planned fiscal strategy, the purpose of which is to reduce the ratio of debt to GDP. The OECD emphasized how the Italian government has adopted "a series of measures aimed at improving the inflow of capital from non-banking sources", including the ACE benefit, which aims to "favor the use of equity funds".

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To achieve this purpose, the Italian legislator grants a final deduction only from IRES taxable income[9] equal to the notional return on risk capital contributions made by shareholders to the company and to the amount of retained earnings.

Finally, it is important to stress that the Italian legislator has also provided several anti-abuse provisions aimed at avoiding the improper use of ACE by Italian taxpayers. The content and scope of these rules are analysed in section 5.

2.2. ACE calculation methods

For joint-stock companies, taxable income is determined according to the rules in the TUIR, specifically the "reinforced derivation principle". This implies referring to the results of the financial statements and modifying the economic result achieved by way of various increases and decreases, which are determined on the basis of specific tax regulations.

ACE is not among the rules that allow for a decrease in a company's taxable income. Pursuant to article 2 of the Ministerial Decree of 3 August 2017,[10] the benefit is applied to taxable income as ordinarily calculated according to Title II of the TUIR. It consists in deducting from total income "an amount corresponding to a notional return on the increase in equity compared to that existing at the end of the year in progress at 31 December 2010".

Therefore, ACE does not reduce the company's taxable income but represents a benefit determined independently from it.

The relevant elements to calculate ACE are:
- any increases and decreases in equity ("ACE base"); and
- the rate used to determine a notional yield.

In order to determine the ACE base, it is necessary to calculate any increase or decrease in the company's equity capital elements in accordance with paragraph 5 of article 1 of Legislative Decree 201/2011[11] and by article 5 of the Ministerial Decree of 3 August 2017.[12]

Increases can include:
- cash contributions;[13] and
- retained earnings, excluding those allocated to unavailable reserves.[14]

Decreases can include:
- reductions in shareholder equity attributed, for any reason, to shareholders or participants;
- purchases of equity investments in subsidiaries; and
- purchases of companies or a company's going concern.

If the algebraic sum of all these elements is positive, this sum must be compared with the value of the company's net equity at the end of the year. The increase in equity capital, in fact, cannot exceed the amount of net equity resulting from the company's financial statements (based on the provisions of article 11 of the Ministerial Decree of 3 August 2017).

If, in contrast, the algebraic sum of all these elements is negative, no ACE benefit is recognized in that tax period.

The rate used to calculate the notional return is set through a specific Decree of the Ministry of Economy and Finance (to be issued by 31 January of each year). The determination of this rate takes into account "the average financial yields of public bonds, which can be increased by a further three percentage points by way of compensation for the increasing risk". For the 2019 financial year, the rate (1.3%) was established directly in the 2020 Italian Budget Law (Law 160/2019),[15] and was aligned "to the latest data relating to the yield of government bonds issued in June 2019".

Pursuant to article 3 of the Ministerial Decree of 3 August 2017, the notional yield (i.e. the amount obtained by applying the 1.3% rate to the ACE base) cannot exceed the total net taxable income declared. Any surplus can be carried forward to subsequent years, but always within the limit of the net taxable income declared in the reference year; in this way, the legislator is attempting to avoid a situation in which a taxpayer, following the use of ACE, benefits from tax losses.

3. The Practical Impact of ACE on the Company: Numerical Examples

The following numerical examples show that there is no correlation between the ACE benefit to an Italian entity (hereinafter Company A) and the royalty received from a foreign entity (hereinafter Company B).

The examples proposed and their scope are as follows:
- Example 1 explains how Company A would have suffered a lower level of taxation in relation to debt capital in comparison to the use of risk capital;
- Example 2 explains that ACE is affected only by changes in the Company's equity and not by the presence or absence of certain types of income, such as royalties or interest; and
- Example 3 explains that royalties or interest received from Company B in 2019 could have, if certain con-

9. The ACE benefit has no impact on the tax base of the regional business tax (IRAP). For this reason, the analysis and the examples shown in this article mainly refer to the IRES calculation.
10. *Supra* n. 7.
11. *Supra* n. 5.
12. *Supra* n. 7.
13. Note that an unconditional waiver of a shareholder's restitution of credits and the offsetting of credits at the time of a capital subscription are considered equivalent.
14. Art. 5(6) of the Ministerial Decree of 3 Aug. 2017, *supra* n. 7, clarifies what is meant by "unavailable profits" for the purposes of the ACE regulation: "reserves formed with profits other than those actually achieved pursuant to art. 2433 of the civil code as they derive from valuation processes as well as those formed with profits actually earned which, by law, are or become non-distributable or usable to increase the share capital or to cover losses; in the year in which the unavailability condition ceases, the unavailable reserves formed after the year in progress as at 31 December 2010 become relevant". Examples include: legal reserves (when they do not reach a value equal to one fifth of share capital), reserves in relation to free increases in share capital and reserves for a voluntary step-up, etc.
15. IT: 2020 Italian Budget Law (Law 160/2019), Italian Official Gazette no. 304 (30 Dec. 2019) – ordinary supplement.

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Table 1 – Risk versus debt capital effect			
Scenario 1-A **Risk capital**		**Scenario 1-B** **Debt capital**	
			Average rate (Company)
Total positive changes in equity from 2010 to 2019 ACE base	800,000	Debt capital	800,000
Rate	1.30%	Interest rate	1.35%
Notional interest – ACE	10,400	Passive interest	10,800
IRES rate	24%	IRES rate	24%
Less IRES due for ACE benefit	2,496	Less IRES due for interest	2,592

ditions are satisfied, a minimal impact in determining ACE for the following year.

Let us assume that Company A recorded the following figures for the purposes of the examples:
- royalty paid by Company B to Company A during 2019 of EUR 4,000;
- net income earned in 2018 by Company A equal to EUR 150,000;
- ACE base equal to EUR 800,000 (related to the period from 2010 to 2019);
- 2019 total revenues of EUR 2,000,000;
- net equity at the end of the 2019 financial year equal to EUR 1,500,000;
- 2019 taxable corporate income equal to EUR 150,000; and
- 1.35% average interest rate paid during 2019 to borrow funds.

Example 1

The following two alternative hypothesis are compared:

Scenario 1-A

Company A decides to allocate net income earned in the previous financial year, equal to EUR 150,000, to retained earnings and not to distribute dividends or rely on debt capital to meet its financial needs. Company A has an ACE base of EUR 800,000, which corresponds to a notional yield of EUR 10,400 (determined by applying the rate of 1.30% to the ACE base).

Scenario 1-B

Company A decides to distribute the entire ACE base, meaning the positive net amount that affected the net equity from 2010 to 2019 (equal to EUR 800,000), and to obtain debt capital in the same amount. The Company, in respect of the latter loan, pays interest that, based on the TUIR, is fully tax deductible in determining its taxable income.

The average interest rate paid by Company A as at 31 December 2019 (i.e. 1.35%) is not higher than that applied by parties under similar conditions and is higher than the rate provided by the Italian legislator for the calculation of the notional yield (1.3%).

The increase in debt capital, to compensate for the distribution of risk capital, implies a payment of passive interest by Company A of EUR 10,800 (= 1.35% × 800,000).

This amount is deductible from business income pursuant to article 96 of the TUIR, as the Company has a gross operating margin[16] capable of guaranteeing full tax deductibility. Therefore, since the interest is fully deductible, in the event that Company A resorts to debt capital, it would obtain a tax savings (equal to EUR 2,592) that is higher than that obtainable under Scenario 1-A in respect of an ACE benefit (equal to EUR 2,496).

Example 2

The second example highlights the fact that royalty income does not affect the ACE calculation. Once again, two hypotheses are compared.

In reaching the above-mentioned conclusion, i.e. both under Scenario 2-A and Scenario 2-B, it is assumed that the algebraic sum of equity variations is negative (EUR -10) due to a hypothetical distribution of dividends and/or purchases of equity investments in subsidiaries.[17]

Furthermore, in respect of Scenario 2-B, it is assumed that the Company will not obtain EUR 4,000 as a royalty. In comparison to Scenario 2-A, this change implies a reduction in:
- total revenue from EUR 2,000,000 to EUR 1,996,000 (equal to EUR 4,000);
- net income from EUR 114,000 to EUR 111,116 (equal to EUR 2,884; i.e. EUR 2,884 = 4,000 – 960 (corporate income taxes – IRES at 24%) - 156 (regional business income tax – IRAP at 3.9%); and
- net equity as of 31 December 2019, from EUR 1,500,000 to EUR 1,497,116 (equal to EUR 2,884).

In Table 2, Scenario 2-A is compared to Scenario 2-B and the values that change as a result of the royalties not being paid are displayed in bold.

These scenarios make it clear that the payment of royalties does not affect, in any way, the possibility to benefit from the ACE rule, which cannot be applied in the absence of net positive changes in the company's equity.

The scenarios show that the royalty income, despite being qualified as Company A's taxable income for IRES and IRAP purposes and being subject to tax (EUR 960, equal to 24% of EUR 4,000 and EUR 156, equal to 3.9% of EUR 4,000, respectively), does not directly influence the determination of the ACE benefit.

Example 3

In this third example, the aim is to highlight that royalties do not affect the calculation of the ACE benefit. For this purpose, a comparison is made between two alternative scenarios.

The example is divided into two phases, where Phase 1 refers to the 2019 financial year, and Phase 2 refers to the subsequent year.

Phase 1

In both scenarios, 3-A and 3-B, it is assumed that the Italian Company A:
- opts for self-financing, thus not distributing the profit earned in the previous year; and

16. *Risultato operativo lordo*, ROL, which is the equivalent of EBIT.

17. For a total of EUR 800,010 (EUR 800,000 – 800,010 = -10).

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Table 2 – Influence of royalty payments in the presence of negative equity variations			
Scenario 2-A **Risk capital**		**Scenario 2-B** **Risk capital and no royalty from Company B**	
ACE 2019 determination		**ACE 2019 determination**	
Total changes in equity from 2010 to 2019	-10	Total changes in equity from 2010 to 2019	-10
Net equity as of 31 Dec. 2019	1,500,000	Net equity as of 31 Dec. 2019	1,497,116
ACE base	**n.a.**	**ACE base**	**n.a.**
Rate	1.30%	Rate	1.30%
Notional interest – ACE	**n.a.**	**Notional interest – ACE**	**n.a.**
Determination of taxable income 2019		**Determination of taxable income 2019**	
Total revenues	2,000,000	**Total revenues**	1,996,000
Taxable income	150,000	**Taxable income**	146,000
IRES rate	**24%**	**IRES rate**	**24%**
IRES on taxable income	36,000	IRES on taxable income	35,040
ACE benefit	**n.a.**	**ACE benefit**	**n.a.**
Net income	114,000	**Net income**	111,116

Table 3 – Influence of royalty payments in the presence of positive equity variations			
Scenario 3-A **Risk capital**		**Scenario 3-B** **Risk capital and absence of royalty from Company B**	
ACE 2019 determination		**ACE 2019 determination**	
Total increases in equity from 2010 to 2018	700,000	Total increases in equity from 2010 to 2018	700,000
Increases of equity in 2019	100,000	Increases of equity in 2019	100,000
Decreases in 2019 equity capital (dividend distribution)	–	Decreases in 2019 equity capital (dividend distribution)	–
Total positive changes in equity from 2010 to 2019	800,000	Total positive changes in equity from 2010 to 2019	800,000
Net equity as of 31 Dec. 2019	1,500,000	Net equity as of 31 Dec. 2019	**1,497,116**
ACE base	800,000	ACE base	800,000
Rate	1.30%	Rate	1.30%
Notional interest – ACE	10,400	Notional interest – ACE	10,400
IRES 2019 **Royalty received from Company B**		**IRES 2019** **No royalty received from Company B**	
Taxable income	150,000	Taxable income	146,000
Rate	24%	Rate	24%
IRES on taxable income	36,000	IRES on taxable income	35,040
Lower IRES payable on ACE* benefit	(2,496)	Lower IRES payable on ACE benefit	(2,496)
IRES 2019	33,504	IRES 2019	32,544

* Equal to EUR 10,400 x 24%.

– all other permanent or temporary differences arising from the accounting and corporate income tax rules (i.e. for IRES purposes) remain the same.

In Scenario 3-B, it is assumed that royalty income, equal to EUR 4,000, has not been paid by Company B. This change implies a reduction in:

– total revenue of EUR 4,000 (i.e. from EUR 2,000,000 under Scenario 3-A to EUR 1,996,000);
– net income of EUR 2,884 (i.e. EUR 2,884 = 4,000 – 960 (corporate income taxes – IRES at 24%) - 156 (regional business income tax – IRAP at 3.9%), which decreases the amount of EUR 114,000 in Scenario 3-A to EUR 111,116; and
– net equity of EUR 2,884, which decreases the amount of EUR 1,500,000 in Scenario 3-A to EUR 1,497,116.

Table 3 compares Scenario 3-A with Scenario 3-B. The values in bold are those that change as a result of the absence of the royalty payment:

One can conclude, in respect of the scenarios outlined in Table 3, that:

– Company B's royalty payment or its absence does not affect, in any way, the value of the ACE benefit (i.e. EUR 10,400) and the "lower IRES payable on the ACE benefit" remains the same under both scenarios (i.e. EUR 2,496); and

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Table 4 – Income taxes paid versus ACE benefit on the royalties			
2019 **Royalty included in IRES taxable income**		**2020** **Royalty included in equity capital changes**	
Royalty	4,000	Net income from Company B royalty	2,884*
IRES rate	24%	Notional interest rate	1.30%
IRES paid on royalty	**960**	**ACE benefit on royalty (lower IRES)**	**37.492**

* This corresponds to the amount of royalties (EUR 4,000) net of IRES (EUR 960) and IRAP (EUR 156) payable.

- the overall IRES due for 2019 is lower under Scenario 3-B (at EUR 960, i.e. EUR 33,504 minus EUR 32,544) solely due to the absence of the royalty payment made by Company B.

The absence of a royalty payment assumed under Scenario 3-B does not affect the determination of ACE, as:
- net income is not included among the positive variations of net equity for the year (i.e. 2019) since its allocation to retained earnings or its distribution to shareholders will only happen and be recognized in the following year (i.e. 2020); and
- the regulatory thresholds provided under Italian legislation continue to be respected, according to which the ACE base cannot exceed net equity in the year in which the benefit is used. In fact, in the event that Company A does not receive EUR 4,000 as royalties, the reduction in net income for the year leads to a corresponding decrease (EUR 3,040) in shareholder net equity (from EUR 1,500,000 under Scenario 3-A to EUR 1,497,116 under Scenario 3-B) but this difference does not affect the reference value for the ACE base, which is the lesser of the positive changes in equity capital and net equity, i.e. EUR 800,000.

Phase 2

If 2019 net income is attributed to retained earnings, this positive change should be considered as a change in equity capital and, therefore, be included in the ACE base for the 2020 financial year.

Only under these circumstances would the royalty paid by Company B, being part of the net income allocated to the net equity of Company A, be considered under the ACE calculation (as it would constitute a positive increase in equity).

The ultimate ACE benefit in 2020 – arising from the net income quota related to the royalty paid by Company B – is, however, in any event, significantly lower than the taxes paid by Company A on the same income in the year in which it was earned (2019).

This assertion can be verified by comparing the values in Table 4.

Based on these examples, it can be concluded that:
- the ACE benefit is not impacted by the accounting of the royalty (phase 1);
- the ACE benefit is not affected by the accounting of the royalty (phase 1) even if the net income is distributed as a dividend in the following year;
- the ACE benefit is not affected by the accounting of the royalty (phase 1) even if the net income is recorded as retained earnings in the following year, but Company A has approved a distribution of other equity reserves in an amount at least equal to the aforementioned net income generated from the royalty; and
- the ACE benefit is indirectly affected by the aforementioned royalty *only* if, in the following year, Company A decides not to distribute any dividends and instead increases the net equity by the net income that accrued in the previous year. Only in this latter case would the benefit indirectly attributable to the royalty recorded lead to a greater ACE benefit. The difference, however, would be inconsequential in comparison to the IRES paid by Company A on such a royalty.

From these examples, it is evident that the key driver of the ACE benefit is not the earning of a particular type of income but the decision of Company A's shareholders on how to direct annual net income resulting from the financial statements.

A decision to:
- distribute the net income as a dividend implies that no additional ACE benefit can be obtained; and
- reinvest the net income in the Company's equity as retained earnings, avoid distributing equity reserves and avoid making cash contributions to a subsidiary allows for an additional ACE benefit to be obtained.

4. OECD Provisions

In 2013, the OECD launched the Base Erosion and Profit Shifting (BEPS) Project[18] to address the behaviour of certain multinational groups seeking to avoid taxation through tax base erosion or profit shifting to another jurisdiction where taxation is lower or nil.

In this context, the Report on Action 2, Neutralizing the Effects of Hybrid Mismatch Arrangements,[19] published by the OECD in 2015, indicates the OECD's position on the double non-taxation phenomenon caused by misalignment.

The Report states that hybrid mismatch arrangements represent an aggressive tax policy tool, as they are aimed at achieving double non-taxation, exploiting differences in tax treatment provided by the laws of two or more jurisdictions in respect of the same entity and/or instrument.

In order to combat this phenomenon, it is necessary to understand the operating methods/tools used by taxpayers to achieve a tax advantage and define the line between lawful behaviour and that which, although not abusive, evasive or illegitimate, is not considered acceptable due to being overly aggressive.

In assessing tax aggressive arrangements, it is first necessary to determine whether the advantage obtained is actually the result of unfair exploitation of a disparity deriving from the combination of the tax regimes of two or more countries, applied by the taxpayer in order to gain an advantage in terms of lower taxation. Second, it is nec-

18. OECD, *Action Plan on Base Erosion and Profit Shifting* (2013), Primary Sources IBFD.
19. *Supra* n. 4.

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essary to verify whether the effect of the misalignment described involves an artificial reduction in the tax base and/or a shift of profits to a state where effective taxation is lower.

Finally, for the purposes of qualifying the taxpayer's behaviour as fiscally aggressive and therefore illegitimate, whether or not the conduct that resulted in double non-taxation was voluntary should be analysed. These aspects make it possible to highlight the intentionality of the taxpayer's behaviour, which is a factor in qualifying the misalignment as aggressive tax planning that should be eliminated or mitigated.

Considering the foregoing, a hybrid mismatch would be a payment capable of giving rise to the phenomenon of double non-taxation. It could be either a payment considered to be deductible in both countries concerned (both the payer and beneficiary jurisdictions) or a payment that is deductible in the payer jurisdiction and not included in the income of the beneficiary jurisdiction.

ACE does not trigger any of the preconditions for hybrid misalignment, as the arrangement in question does not involve:

- double deduction (DD): royalties paid by Company B to the Company A are, by their nature, qualified as positive components of income (revenue), which obviously cannot be considered as negative components of income (costs); therefore, these payments are not deducted from the Company's business income; and
- deduction/non-inclusion (D/NI): the aforementioned income is ordinarily fully included in the taxable income of the Company, as represented in the examples proposed in the previous section.

ACE is, in no way, connected to any type of payment or expense incurred by a resident in another state. More precisely, ACE is not directly or indirectly linked to the payment of royalties and/or interest and/or income from the sale of finished products and/or the provision of services.

In fact, ACE is based on increases and decreases in equity capital during a specific period of time. The notional yield is deducted only from total taxable income calculated for tax purposes, according to the applicable Italian tax legislation. Total taxable income includes all income accounted for by Company A, including the royalty received from Company B.

5. ACE and the Fight against Evasive Conduct

As argued in section 4., the design of the ACE framework is aimed at:

- encouraging companies to strengthen their capitalization through risk capital; and
- reducing fiscal disparities between companies using debt capital and those that finance themselves through risk capital.

Therefore, in order to prevent taxpayers from using the ACE regime to obtain undue tax advantages or to pursue illegal purposes, the Italian legislator has established a variety of rules designed, on the one hand, to avoid illegal/fiscally advantageous situations and, on the other hand, to ensure a level of consistency in the taxation of corporate income at an international level, in compliance with the OECD provisions.

In this sense, the ACE benefit is in line with the standards of the BEPS Project, including specific recommendations on how to draft national legislation and international measures to neutralize the tax effects arising from the application of hybrid mismatch arrangements.

In this regard, it is important to recall that, in implementing ATAD 2 into national legislation,[20] the Italian legislator expressly declared that the ACE benefit does not represent a hybrid mismatch. The *ratio* underlying this statement is found in the Explanatory Report to the Implementation Decree (*Relazione Illustrativa al Decreto di attuazione*),[21] which specifies that the benefits deriving from the ACE or similar regimes provided under foreign legislation do not lead to hybrid mismatches, as they are not attributable to cash flow.

The Italian law provides for a specific provision in order to avoid the use of the ACE regime to achieve illegal tax advantages; these provisions are both implicit – that is, the provision can be inferred from the content of the law itself – and explicit – i.e. included in specific anti-avoidance rules.

The implicit provisions are the following ones:

- the overall net positive increase in net equity, due to equity contributions made since financial year 2010, can never exceed the current amount of net equity, thus preventing any possible arbitrage opportunity;
- the notional interest rate is fixed by law and, therefore, is not subject to potential speculative assessments;
- the notional yield cannot exceed declared net taxable income, which prevents the use of the ACE benefit to generate a tax loss carry-forward; and
- Company A's taxable income is always calculated according to ordinary tax rules provided under the TUIR in determining business income tax. The ACE benefit is deducted at a subsequent stage and is not recorded in the financial statements, even if its use reduces the final amount of corporate income tax (i.e. IRES) due.

The explicit provisions are mentioned in article 10 of the Ministerial Decree of 3 August 2017, wherein the Italian legislator expressly forbids groups of companies from multiplying the benefit.

20. IT: Legislative Decree of 29 Nov. 2018, no. 142, Implementation of Council Directive (EU) 2016/1164, of 12 July 2016, laying down rules against tax avoidance practices that directly affect the functioning of the internal market and as amended by Council Directive (EU) 2017/952 of 29 May 2017, amending Directive (EU) 2016/1164 relating to hybrid mismatches with third countries, Official Gazette no. 300 (28 Dec. 2018) – ordinary supplement.
21. Explanatory Report to the Implementation Decree (*Relazione Illustrativa al Decreto di attuazione*), available at www.governo.it/sites/governo.it/files/La_Relazione_Illustrativa_.pdf.

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For example: assume an injection of capital risk from shareholders to Company A. The latter decide to inject a portion of such contributions into Subsidiary C. The positive variation in the net equity of Company A must be reduced by the cash contribution made in favour of Subsidiary C, regardless of the maintenance of the control relationship at the end of the financial year.

In addition, note that ACE does not involve any exceptions:
- to the *global taxation principle*, as the income of a taxpayer resident in Italy is taxed in Italy, regardless of the source; or
- to *the business income attraction rule*, according to which any income related to the business activity is taxed as such, regardless of its potential objective classification.

Therefore, in this scenario, Company A is subject to IRES and determines its taxable income pursuant to the application of the TUIR. The payments made by Company B are included in the business income earned by Company A and consequently subject to tax in Italy regardless of whether or not the subject chooses to take advantage of the ACE benefit.

6. Conclusion

The purpose of the Italian regulation is clearly expressed in the Explanatory Report to the Ministerial Decree of 14 March 2012,[22] which states[23] that: "the objective pursued by ACE, taking into account the need to strengthen the country's productive apparatus, is to encourage the capitalization of companies by *reducing taxation on the resulting income from debt capital*. This is a *rebalancing measure*, in the sense that ACE is intended to improve the disadvantageous treatment of risk capital with respect to third-party capital" [author's translation and emphasis].

It is, therefore, a fiscal incentive reserved for holders of business income, in order to relaunch the country's economic development and provide growth aid, facilitating companies that strengthen their capital structure.

ACE is granted for the sole purpose of reducing or neutralizing the disparity in tax treatment between companies that finance themselves through risk capital and companies that use debt capital: this target is substantially achieved thanks to the notional interest expense deduction. The ACE rule discourages the distribution of dividends in order to favour greater capitalization of companies.

The analysis carried out herein affirms that the regime is not capable of exempting certain categories of income that are determinative of the company's taxable income.

The key driver of the ACE benefit is not the earning of a particular type of income but only the decision of the shareholders of Company A regarding the destination of the annual net income resulting from the financial statements. The analysis herein also indicates that the 2019 ACE benefit is not affected at all by royalty payments made by Company B to Company A in financial year 2019.

The royalty paid in the example by Company B to Company A (EUR 4,000) is included in full in Company A's taxable income and subject to tax at a rate of EUR 1,116 (overall tax rate of 27.9%) as follows:
- corporate income tax (IRES of 24%) resulting in an amount of EUR 960; and
- business regional tax (IRAP of 3.9%) resulting in an amount of EUR 156.

The ultimate and indirect benefit deriving from the ACE (EUR 37.492), in the following tax period, has an impact of 0.94%[24] on the amount of the royalties paid by Company B, thus decreasing the overall tax rate from 27.9% to 26.96%. For these reasons, the ACE benefit cannot be considered as a hybrid mismatch instrument subject to BEPS Action 2.

22. Explanatory Report to the Ministerial Decree of 14 Mar. 2012, Official Gazette no. 66 (19 Mar. 2012) – ordinary supplement. The Ministerial Decree of 14 Mar. 2012 contains the first operative provisions regarding the ACE regime.
23. In Italian: *l'obiettivo perseguito con l'ACE, tenendo conto delle esigenze di rafforzamento dell'apparato produttivo del sistema Paese, è quello di incentivare la capitalizzazione delle imprese mediante una riduzione della imposizione sui redditi derivanti dal finanziamento con capitale di rischio. Si tratta di una misura di riequilibrio, nel senso che l'ACE intende migliorare il trattamento di sfavore del capitale di rischio rispetto al capitale di terzi.*
24. 0.94% = EUR 37.492 / EUR 4,000.

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