Italian tax reform

compatibility of the extraordinary contribution with EU law/guidelines

The design of the new Italian contribution is driven by the VAT rules

On March 21, 2022, the Italian government has published the Law Decree No. 21/2022 providing urgent measures to contain energy prices and counteract related economic effects, including the introduction of a windfall profits tax on qualifying energy enterprises (article 37).

The Law Decree must be converted into law by the Italian parliament (with possible amendments) within 60 days from its publication.

This extraordinary solidarity contribution (*contributo solidaristico straordinario*) is presented as a one-off tax that shall be paid by energy undertakings (producer, importer and retailer of electricity/gas/petroleum product) operating in Italy[1].

Its taxable basis is defined as the increase of the net VAT balance[2] reported during Winter 2022 (from 01 10 2021 till 31 03 2022) and the net VAT balance reported during Winter 21 (01 10 2020 – 31 03 2021).

Since this new contribution is based on an increase of a net VAT balance, its taxable basis includes only transactions included in the VAT scope. Therefore out of scope transactions, like some operations between a foreign headquarter and its Italian branch, OR, financial hedges, are not taken into account for the computation of the taxable basis whereas they can be key in the business model of energy companies.

No tax is due if the increase does not exceed either a fixed amount of 5 M€ or a relative amount of 10%.

The contribution should initially apply at the rate of 10%. However, early May, the Italian government announced its intention to increase the rate to 25% considering the need for additional stimulus.

The tax must be paid by 30 June 2022 and it is not deductible for corporate income tax (IRES and IRAP) purposes. The domestic VAT provisions apply with respect to related assessments, penalties and collection and litigation activities, even if this contribution is not per se a VAT.

This new contribution raises several concerns regarding its compatibility with EU law (2) and the guidelines recently issued by the Commission to frame tax measures taken at national level (1).

1. **The new Italian tax does not follow the guidelines made by the Commission in its "RePower EU" communication on the 8th of March, entitled "Guidance on the application of infra-marginal profit fiscal measures"**

To finance emergency measures decided by Member States, the communication mentions that "*Member States can consider temporary tax measures on windfall profits*", that "*such measures should not be retroactive, but should be technologically neutral and allow electricity producers to cover their costs and protect long-term market and carbon price signals*" and finally "*Annex 2 sets out the conditions those instruments should meet*".

[1] "persons who carry on business in the territory of the State, for the subsequent sale of goods, in the production of electricity, persons who produce methane gas or extract natural gas, persons who sell methane gas and natural gas and persons who produce, distribute and trade in petroleum products"

[2] Net VAT balance is defined as all transactions subject to output VAT (sales subject to VAT) minus all transactions subject to input VAT (purchases subject to VAT) during the reference period.

Despite the warning to design an exceptional tax without creating unnecessary market distortions, to incentivize additional investment in renewable energy, the tax basis defined in the new Italian Law Decree does not reach this goal.

Three examples could be provided :

1. Case of an undertaking operating in Italy through a branch : a foreign company selling gas or power (via a network) through an Italian branch will include in its output VAT basis the sale of energy to its Italian clients but will not include the "purchase" of energy from its foreign headquarter by application of Article 17 2 d) of the VAT Directive. So its liability to the new tax could be significantly different from an Italian subsidiary for which both the purchase and the sale of energy (delivered via a network) are subject to VAT and reported in the VAT return.

2. Case of a company investing/divesting during the reference period : acquisition/disposal of assets are subject to VAT and so are reported in the VAT return and therefore included in the computation of the tax basis of the new tax. Therefore, a company which made investments requiring the acquisition of assets during the Winter 2021 increased the initial reference of net VAT balance, and, thus reduced the basis of the new tax, regardless of the price of the energy. The reverse applies for a company having invested during the Winter 2022, it increased the basis of the new tax, irrespective of the energy prices.

3. Case of a company having hedged financially its futures revenues : since most energy companies hedge all or most of their revenues with physical or more often financial transactions, their income is usually pre-defined and barely impacted by the volatility of the market on the short term. Due to the fact that the new tax disregards financial transactions which are outside the scope of VAT, a company may have realized high revenues when selling on the market at a high price during Winter 22, and, incurred significant losses on its financial hedges over the same period. In such a case, its taxable basis for the new tax will be much higher than the economic income realized by the company.

Please see in the exhibit to this note, a table analyzing, in more detail, each condition listed in the Annex 2 of the REPowerEU Communication vis à vis the new Italian tax**. It clearly comes out that the Law Decree lacks to respect many requirements.**

2. Three areas of EU law can be considered to identify potential infringements with EU law

- Compatibility of the new Law Decree with the **freedom of establishment**

As explained above, the new Law Decree treats branches of EU companies that are established in Italy differently from Italian subsidiary due to the fact that only transactions included into the scope of VAT are taken into consideration.

According to Article 49 of the Treaty on the Functioning of the European Union (TFEU), restrictions on the freedom of establishment, including restrictions on the setting up of agencies, branches or subsidiaries by nationals of a Member State in the territory of any other Member State are prohibited. The freedom of establishment, as far as secondary establishments are concerned, gives a national of a Member State the right to choose freely its form of establishment in the host state, i.e. a branch or subsidiary, making any restrictions imposed by the host state incompatible with the provisions of article 49 of the TFEU. No overriding reasons in the public interest appropriate and necessary for ensuring the objective of the Law Decree have been identified.

- Compatibility of the new Law Decree with **State Aid rules**

In the light of EU State aid law, Member States are prohibited from adopting measures that lead to an economic advantage for certain undertakings or sectors and thus, distort competition. Therefore the design of a tax shall be consistent and proportionate with its objective.

In case of a windfall tax measure such as the one under consideration, the tax shall proportionately affect all the undertakings having benefited from the high energy prices. Should the EC consider that the new tax constitutes an incompatible State Aid, Italy should recover the tax from exempted undertakings.

Therefore, this proceeding would not reduce the financial impact for the group but would reduce the unfair treatment as compared to exempted or less impacted undertakings.

- Compatibility of the Law Decree with the **1st Protocol to the European Convention on Human Rights (ECHR) protecting the property right**

Article 1 of this first protocol provides that :

Every natural or legal person is entitled to the peaceful enjoyment of his possessions. No one shall be deprived of his possessions except in the public interest and subject to the conditions provided for by law and by the general principles of international law.

The preceding provisions shall not, however, in any way impair the right of the State to enforce such laws as it deems necessary to control the use of property in accordance with the general interest or to secure payment of taxes or other contributions or penalties.

This provision applies to tax matters and limit the possibility of States to levy taxes which indirectly requires State to take into account the ability to pay of the taxpayer often protected by national constitution (like in Italy) and referred to in several case law of the European Court of Justice. According to the case law of the European Court of Human Rights, the levying of a tax is contrary to the respect for property if it imposes a "special and exorbitant burden" on the person who has to pay it.

Since the design of the new tax does not take into consideration material items of the wealth or profitability of a company (depreciation, financial derivatives, excise duties included in the output VAT basis but not in the input VAT basis….), it can lead to a confiscatory tax.

In addition, since Winter 2021 was adversely impacted by the sanitary crisis which resulted into depressed energy prices, the reference between the two winters is inappropriate to compute a tax targeting only windfall profits and could lead to an excessive tax.

The mechanism of the new tax can even be irrational : a loss making company which has reduced its losses during Winter 2022 as compared to Winter 2021, can be subject to the windfall tax while remaining in the red.

Finally, the non-deductibility of the new tax from the corporate income tax (IRES+IRAP) increases its economic impact for a company and therefore the effective rate amounts rather at 35% (25%/(1-CIT rate of c.28%)).