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Italy 2016: The New Tax and Regulatory Frameworks for Banks

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An overview of “bail-in”, execution of banking law reforms, tax reform and the 2016 Finance Law

Preface

In the past couple of years we announced and commented on many tax and regulatory reforms affecting Italy.

Looking back at the past months, we can state that by 1 January 2016 all of the proposals and drafts we commented have become law, though in some cases the effective application is still pending due to the lack of administrative decrees or execution provisions which, however, will follow in the course of 2016.

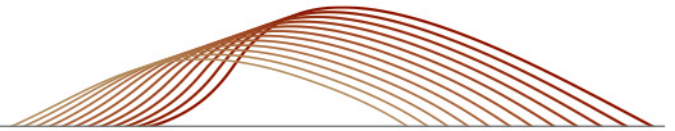
Analytical comments are not possible here since the reforms are extremely wide and touch upon many areas.

Our more limited aim is to provide some guidance in respect of what we consider the main topics among such a high number of new provisions, so that banks operating in Italy will be able to understand both what they should do immediately and what they should expect in the very short term.

From a different perspective, we think there is a need to summarise all the regulatory and tax reforms enacted in the course of 2015, add some interesting provisions contained in the Italian Finance Law for 2016 and provide some suggestions about risks and opportunities arising from such very new and apparently fragmented scenarios.

We will also underline the extraordinary links between regulatory and tax provisions which exist now.

It is in fact our belief that while in the past, banking taxation and banking regulation were highly differentiated and could in no way be looked at within a unitary perspective, in the past couple of years banking and tax regulation in Italy (and, more widely, in Europe) have marched towards a stricter and stricter combination and reciprocal influence.



Furthermore, Tax has gone “upstairs, to the Boardroom”, as wished by OECD in its Tax Papers of the last decade, while Regulatory topics have gone “downstairs”, from an almost exclusive presence within the Boardroom and Top Management, down to all management levels.

All this will have an impact on entrepreneurial culture, corporate governance, internal organisation and economics of banks.

The New Regulatory Framework: “Bail-In”, Execution of Banking Law Reform and Other Provisions

The true news of 2016 in regulatory matters is the entry into force of “bail-in” rules on 1 January 2016, which provides for a totally new framework in case of bank and investment company resolutions.

“Bail-in” rules are contained in Legislative Decree n.180 of 16 November 2015, published the same day in the Italian Official Gazette.

However, Italy has partially anticipated the entry into force of “bail-in” rules in the resolution of four Italian banks, namely Banca Marche, Banca Popolare dell’ Etruria e del Lazio, Cassa di Risparmio di Ferrara, Cassa di Risparmio di Chieti.

This took place through the Decree-Law n.183 of 22 November 2015, whose provisions were incorporated in the 2016 Italian Finance Law (*Legge di Stabilità 2016*), Law n.208 of 28 December, published in the Official Gazette of 30 December 2015.

The practical “bail-in” of the four banks came as a shock for investors, especially those who had invested in the banks’ subordinated bonds.

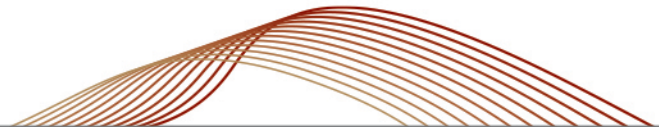
It was the first time that investors lost all their money invested in Italian bank subordinated bonds, and this, though in a very harsh way, has given the public a sense of how deep the post-crisis regulatory reforms will be and how different investor behaviour will have to be in the future.

In a way, the potential effects of “bail-in” rules have appeared for the first time in the Euro-area.

In such a partial “bail-in”, only the accounts over Euros 100.000 have been preserved.

As of today, what has not yet entered into force though a logical framework to the bail-in, is the new banking administrative penalty system (for details see our Client Alert “Hard Times Ahead for EU Banks and Bank Officers. The new CRD IV Penalty System” of 8 May 2014) which, in our view, will provide a further strong change in the bank and financial environment. Banks will be subject to penalties which could equal 10% of their consolidated turnover while for all the employees, executives, directors and auditors penalties are generally fixed within an amount between 5.000 and 5 Million Euros. Supervisory Authorities will also have the power to remove executives and directors.

Such new penalty system was definitively introduced by Legislative Decree n.72 of 12 May 2015, which amended various provisions of both the Italian Consolidated Banking Act (Legislative Decree n.385 of 1 September 1993) and the Consolidated Finance Act (Legislative Decree n.58 of 24 February 1988) and added to other EU specific provisions.



The condition of the entry into force of the new system is the publication by Bank of Italy of a new regulation, which will abolish the current regulatory provisions provided by the regulation of 27 June 2011.

The mandatory public consultation by Bank of Italy ended on 16 November last year.

Furthermore, since penalties under market rules should have also been updated, CONSOB, the Italian market regulator, initiated a public consultation on an update of its rules related to application of penalties, Decision n.18750 of 19 December 2013, which ended on 7 December.

It is expected that the final regulations will be published very soon, thus enabling the Italian Banking Supervisory and Market Authority (Bank of Italy and CONSOB) to apply the new rules, for which it has been finally clarified that they will not have any retroactive effect.

The latest development is the approval by the Government of a draft legislative decree on 15 January by which the application of such penalty system is substantially extended also to asset management companies (SGR: *Società di Gestione del Risparmio*).

Differently from the current system, the new system will potentially reach all bank employees at any level and not only the Board, the Top Management and the Board of Statutory Auditors. Employees of outsourcers will also be liable to penalties. In order to materially calculate the penalty, the Bank of Italy's new draft regulations specify that the reported violations attributable to employees will consider their payroll of the last three years.

On the other hand, more legal guarantees and protections for banks subject to penalty application have been granted during the penalty application procedure.

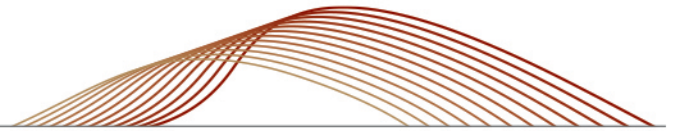
Another 2016 hot topic for banks is sound remuneration policies. On 21 December 2015 the EBA published its Final report on Guidelines on sound remuneration policies, which will become effective on 1 January 2017.

Thus, in the current year it will be crucial to take all decisions and set remuneration policies for the future.

The application of such EBA rules to medium and small size financial intermediaries remains uncertain. EBA has issued a paper about the proportionality principle which, while it confirms that under CRD IV no waiver can be granted, a revision of CRD IV provisions is suggested in view of allowing less strict rules for smaller financial enterprises. The EU Commission will take the final decision whether to make a step in this direction or take a standstill position.

Also Mifid II shall enter into force on 1 January 2017, while the Market Abuse Regulation will enter into force in July 2016.

There is a further long list of other EU provisions enacted during 2015, like the Payment Services Directive II (PSD II), the new Anti-Money Laundering Directive (AML IV), the Delegated Regulation adopted by the EU Commission on 6 August implementing the clearing obligation for some classes of interest rate OTC derivative contracts, and many others. Effective application will still take some time.



Some Remarks and Suggestions

The year 2016 can be seen as a key period for the effective implementation of all such measures which are radically changing the EU financial system.

Taking a view from above, it seems clear that under the new bail-in rules together with the soon-to-come new penalty rules on banks and bank officers and the application of new EU provisions, both directly (EU Regulations) or through transposition into national law (Directives), Supervisory authorities will be provided with powers unknown in the past while investors, retail and corporate customers will receive much higher protection than ever.

Italy will not be an exception to this.

Pressure on compliance, capital adequacy, good governance practise, monitoring excessive risk taking, putting in place sound and effective internal control systems, customer protection internal rules and procedures will increase substantially; as Directive 36/2013 (CRD IV) clearly tells, the main role of the Board will be to control management, so Boards will also put more pressure on bank management towards the same direction.

In our view, together with updates of business strategies and targets, steps which financial intermediaries need to evaluate now and put in place as soon as possible include timely updates of internal policies, the taking of prompt decisions, the avoidance of delays in making the necessary changes of internal organisations, clarifying internal roles and functions and effective training for employees.

To this purpose, strong legal and compliance support in order to be aware of the many updates in the framework, and also in order to protect the company during administrative proceedings and before taking judiciary oppositions, becomes essential: the key words will be “competence”, “independence” and “experience” , especially from the perspective of international experience since the use of best practices as benchmarks will no longer be domestic but at a EU or even wider international level, but also for managing pure domestic issues.

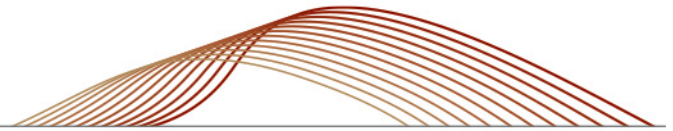
The New Tax Framework: Execution of the Tax Reform and 2016 Finance Law

The long legislative process of the Italian tax reform ended in the last quarter of 2015. Legislative provisions are all in place although most of the provisions await material enactment through administrative decrees to be issued mainly by the Italian Tax Agency.

The new tax cooperative compliance framework and the new and updated tax “white list” are only a few examples of what is still missing.

On the other hand, the new criminal and administrative penalty system in tax matters is already in force. In respect of the latter, the Italian Tax Agency has provided specific guidance about the timing of the application of the new system.

In respect of the new criminal tax system, it should be kept in mind that such system will have to be coordinated with the re-writing of the criminal offence popularly known as “false accounting” (*reato di false comunicazioni sociali*, ex art.2621 of the civil code), which has strong links and potential interactions with criminal tax matters.



It is clear that such new penalty systems and other criminal offences do not only relate to banks, but we will explain later that, due to tax and regulatory rules interactions, banks will be hit harder than other taxpayers by these new rules.

However, all that we had anticipated in our “What foreign investors should expect from the Italian tax reform”, a client alert of 3 February 2014, and “SOX Section 404, Fin 48, OECD papers: international experience to mark the Italian way to tax cooperative compliance”, another client alert of 11 June 2015, has finally become real.

Further developments are contained in the above-mentioned Finance Law for 2016.

The main provisions which affect banks (and all financial intermediaries, with the sole exception of insurance companies) and will enter into force starting from 1 January 2017 are on one hand the elimination of the 3% interest non-deductibility threshold, thus making passive interest fully deductible for banks, re-establishing the regime in force before 2008, and the non-extension to banks of the reduction of the corporate income tax rate from the current 27,5% to 24%.

Such reduction will take place for all Italian resident corporate entities (always with effect from 1 January 2017), but, as anticipated, will not affect banks, who will continue to pay a substantial 27,5%. From a formal point of view, the corporate income tax rate will be 24%, but the banks will have to pay a special surcharge on income of 3,5%.

The rationale for this lies in the deferred tax assets (DTAs) position of Italian banks, which constitute an essential part of bank regulatory capital. Such peculiar feature is due essentially, but not limited, to tax effects over depreciation of non-performing loans. Historically and until 2014, tax depreciation of credit devaluations was allowed through a very long lag time, which has variously been five years, six years, nine years and even up to 18 years. By doing so, the financials of Italian banks, also under IAS principles, were extremely different from the tax results.

According to Basel III rules and under certain conditions (which are normally met), DTAs have been recognised as bank regulatory capital.

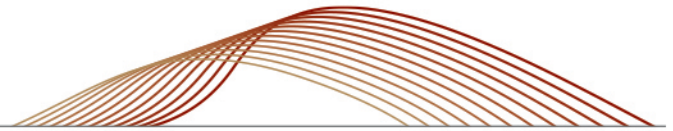
In a nutshell, a decrease of the corporate income tax rate would have resulted in the decrease of DTA amounts, thus a decrease of regulatory capital. This consequence has been avoided.

A direct intervention over bank DTAs has also been taken in respect of the date of the right to turn DTAs into negotiable tax credits, which, in the case of a bank resolution, will start on the date of effect of the resolution. The date of the effect of this measure is 1 January 2016, which is also the date of entry into force of the bail-in legislative decree mentioned above.

Before the enactment of this new provision, the conversion of DTAs into tax credits could happen at the end of the bank resolution (now it is at the beginning).

This measure is also meant to strengthen the rationale, coherence and legitimacy of DTAs as part of regulatory capital.

A further important new provision contained in the 2016 Finance Law is the tax incentive for the acquisition or lease of new assets; its validity dates back from 15 October 2015 and extends until 31 December 2016.



The application rules of the incentive are very easy, a feature which was not very common in the past and had led the Tax Agency to provide very strict interpretations of the tax incentives, whose rationale sometimes appeared lost or too burdensome.

The acquisition cost will be simply increased by 40% for tax purposes and the amortisation will take the effect of such increase from a tax standpoint.

From a different perspective, there will be no change in the amortisation from an accounting perspective, while the amounts of amortisation will be higher from a pure tax perspective, thus reducing the overall tax rates.

Such incentive applies to any kind of company and also to professional individuals.

Only a few kinds of assets are excluded from the incentive, as for example railway materials, water pipes for water bottling and for thermal plants, certain gas pipes, fully equipped airplanes and a few other goods.

From a different standpoint, this incentive should boost the business of leasing companies and at the same time increase financing of new investments, which implies new business also for banks.

Last but not least, during 2015 Italy executed the FATCA agreement and starting from 1 January of this year financial intermediaries have started to collect and organize internal data in view of the application of Common Reporting Standard Rules from 1 January 2017 (with few exceptions, like Switzerland, for which the tax information exchange will start one year later).

A New Phenomenon for Banks: Banking Regulation's Strong Influence on Taxation

By reading the previous paragraphs, it is in our view evident how much regulatory constraints have driven the Italian tax legislator.

The bail-in rules have been strictly connected to conversion of DTAs into tax credits, reversing previous interpretations of the Tax Agency.

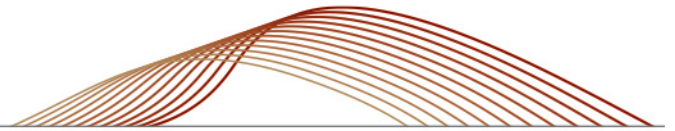
From a more practical perspective, the Banking Supervisory Inspectors have also started to review bank internal control systems on tax management according to the implementation rules of CRD IV.

Controls over risk minimization have always been assigned to Supervisory Authorities, but never in the past has this had any impact on tax management.

Now it has, and the impact is going to be very deep as soon the new penalty rule comes into force.

This also entails that internal tax management will have to be more consistently connected with regulatory managers. Both will have to enlarge their cultural background to reciprocal domains.

External advisors and lawyers will have to do the same.



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