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THE CAPITAL GAINS DEFINITION IN ITALY (*)

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SUMMARY: I. *General Rules.* 1. Description of the Framework of Capital Gains Treatment. - 2. Ordinary Income and General Gains Distinction. - 3. Legal Basis of Capital Gain's Definition. — II. *Main Factors in Capital Gains' Classification.* 1. Property Character. - 2. Nature of Disposition. - 3. Holding Period and Circumstances. - 4. Inflation. — III. *Distinction between Investments and Business Activities.* 1. General. - 2. Trade or Business Badges. - 3. Business Goodwill. - 4. Depreciable Business Assets. - 5. Non-depreciable Business Assets. IV. *Distinction between Investment and Speculation.* 1. General. - 2. Holding Periods. - 3. Other Factors. — V. *Profits from the Rewards of Personal Efforts.* — VI. *Transactions Involding Recurring Receipts.* 1. General. - 2. Disposal Retaining Interests. - 3. Returns of Capital, Compensations and Damages. — VII. *Transformation of Tangible into Intangible Assets.* — VIII. *Transformation of Ordinary Income into Stock Appreciation.* — IX. *International Aspects.* 1. International Law Provisions-General. - 2. International Agreements Rules. — X. *Conclusions.*

I

1. In principle, the tax law in force in Italy includes capital gains (*plusvalenze*) in the income definition: consequently, they are subject to ordinary income taxes provided for by the various fiscal Acts, i.e. the individual or corporate income taxes, respectively called IRPEF and IRPEG (Presidential Decrees, n. 597 and 598 of September 29, 1973), and the local income tax, called ILOR (P.D. n. 599 of September 29, 1973).

There is, however, for capital gains from real estates situated within the Republic, a more particular duty, called INVIM (P.D. n. 643 of October 26, 1972), which can be added to the income taxes: in this case, in order to avoid double taxation, the amount of INVIM due is deducted from capital gains subiect to income tax.

As a rule, realization is required in order to tax capital gains: there are, however, many exceptions to this rule. E.g., the increase of value of a property belonging to a partnership

company, corporation and so on, though unrealized, is taxed as income when allocated in the balance. Moreover, some events, which do not involve any transfer of property, are considered as realizations: e.g., the application of a property relevant on business term for the owner's private use or others which are not so connected with the business activity.

2. Capital gains are distinguished from ordinary incomes by their unreproducible nature: indeed, while ordinary incomes arise from a perpetual source, which remains under the subjects' control, capital gains are carried out once for all. Consequently, as far as the business entities go, capital gains are considered as profits relevant to « assets », the production or sale of which are not the object of the business activity.

This principle is to be considered, of course, only in income tax matters, INVIM being indifferently levied on all real estates appreciations, without any distinction between ordinary and extraordinary profit. E.g., the profit obtained by the sale of a building will be considered from the income tax point of view, as an ordinary income if the vendor is a builder, but as a capital gain if his activity does not consist in building or in dealing in real estate; vice versa, in both cases the realized increased value will be liable to INVIM.

The aforesaid difference between capital gains and ordinary incomes, is based, therefore, on the taxpayer's nature, because it depends on his activity, regarding the object (asset or goods) in question.

3. The capital gain concept in Italian income taxation, has a statutory basis. There are, fondamentally, two definitions, one concerning the assessment of business income taxes, and others regarding private persons and non-profit institutions.

The former definition, which concerns both individual and corporate businesses, is set out in art. 54 of the P.D. n. 597/1973,

on individual income tax, and referred to in art. 5 of the P.D. n. 598, on corporate income tax assessments: accordingly, capital gains consists of *the difference between the greater value which is realized and the last value estimated for income taxation matters*, less direct costs and, if relevant, the INVIM amount.

The latter definition, regardind private persons' taxation, is to be found in art. 76 of the P.D. n. 597, which provides that capital gains, liable to income tax, consist of *the difference between the selling price, less INVIM if due, and the purchase price increased by costs of the asset transferred.* This definition is adopted even by art. 20 of the P.D. n. 598, concerning income taxation of nonprofit institutions and corporate bodies.

II

1. For income tax purposes, the capital asset character is not important as regards the definition of capital gains: however, as we shall see, it may affect the treatment of capital gains.

Therefore, the distinction between personal and real estates does not concern this definition, though it involves some changes in the rules on taxation.

On the contrary, for INVIM purposes, only real estate is to be considered.

On the other hand, there is no specific exclusion of particular properties from the definition of a capital asset.

2. The nature of the disposition is relevant both in income taxation on capital gains and for INVIM purposes, because, while the realization of the asset, which is normally necessary for the capital gain account, depends on this nature, the INVIM is applied on the occasion of certain disposals, involving the transfer of property.

For the purposes of income taxes, there is no general definition of « realization », nor are there specific statutory exclusions;

but many qualifyng standards hare been established by case law: we may say approximately, that realization consists in the exchange of a capital asset. There are, however, a great many debated questions. E.g., while it is undoubted that bequests are not relevant to capital gains taxation, it is disputed whether a deed of gift can give rise to a realization of capital gain: the affirmative solution is backed by some writers (see, e.g.: FALSITTA, *Lezioni sulla riforma tributaria*, Padova, 1972), but the judicial decisions prevailingly hold a contrary opinion (see, on this point: Comm. centr., dec. n. 68976 of March 1, 1963). Of course, this question arises only if the deed of gift does not involve a realization for another motive: e.g., because this asset, which was used for business purposes, is destined for non-business uses.

As for the rest, our tax law does not require any specified method of property transfer — the exchange may take place either as a sale or permutation, payment in kind, satisfaction of a claim, contribution to a company, etc. The only requirement, in default of which a disposal might not be classified as a realization and thus for capital treatment, consists in its voluntary nature: therefore, a compulsory transfer of property does not constitute an occasion for capital gains treatment. E.g., the expropriation of a property due to an administrative measure or a forced sale is not within the sphere of disposals relevant to capital gains taxation, because this transfer is not undertaken by the owner, but the will of an administrative or judical authority. Likewise, the conversion of property in consequence of events beyond the owner's control, such as theft or destruction, does not give way to capital gains taxation. On the other hand, when the conversion depends on the will of the owner, even if conditioned by unfavourable circumstances — such as, e.g., if a property was sold in order to avoid its forced sale — it may be relevant to the purpose of capital gains treatment: hence bequest, and, more generally, hereditary successions are not to be considered as « realizations » for capital gains treatment.

Whereas, for the INVIM purposes, we find exceptions to these rules: not only gifts, but even bequests and successions of real estates attract taxation. However, these exceptions are only apparent: in fact, INVIM is charged, in these cases, on the beneficiary of the succession (heir, devisee, or donee), and thus it assumes, on this side, the character not indeed of capital gain but of estate acquisition tax.

3. Our income tax law as a rule does not require any holding period for capital gains teatment: in fact while for capital assets connected with the owner's trade or business (whether an individual or a corporate person) there are no particular requirements apart from the « realization », for assets having a private destination it is required that the sale or exchange of the capital asset is characterized by a speculative purpose.

However, the holding period is sometimes considered just as an indication of this purpose: there are even some statutory provisions in this sense, which lay down presumptions of speculative purposes in relation to holding periods of some categories of capital assets, as will be explaind in more detail in paragraph IV, 2, *infra*.

The number of transactions in the taxable year is not important as a specific requirement, but it may be taken into account in order to establish if the capital asset is connected or not with the taxpayer-s trade or business.

Likewise the fact that the profit from the sale of a property is reinvested in acquisition of other property is not a relevant factor in determining the nature of the capital gain, buf it is a factor in capital gains treatment: in fact, as it is provided by art. 54 of the P.D. n. 597, the capital gains achieved by the sale of a capital asset relating to business terms are exempted from income taxes, if set aside in a special fund, on condition that they are reinvested within the following two years.

As we have seen (paragraph I, 3, *supra*), the fact that the taxpayeyr is a corporate and not an individual person is not a relevant factor in the capital gains definition: for the question is the difference between business or non-business activities, whether they are practised by corporate or individual persons.

4. It is a contentious point whether or not inflation should be taken into consideration for the definition of capital gains. (cfr., on this point: *I problemi delle imprese di fronte alle variazioni dei prezzi e dei cambi*, Acts of VII Congress of *Società Italiana per lo studio dei problemi fiscali — Italian Section of I.F.A.*; *Imposte e inflazione*, Milano, 1976). Authoritative sources state that capital gains are constituted only by real increases in value: hence, when the appreciation of an asset depends on depreciation of currency, it would not be regarded as a source of capital gain. There is also, in this sense, an important sentence of the *Corte di Cassazione* (n. 2874 of October 16, 1974).

III

1. The distinction between *investments* and *business activities* is applied in our tax law in order to exclude from capital gains the every day profits of the business and commercial world (On this point, notice: SURREY, *Definitional Problems in Capital Gains Taxation*, 69 *Harvard Law Review*, 1956, 985).

This distinction is based, as we have already seen (paragraph I, 2, *supra*), on the nature of the property, when it has to do with a taxpayer practising a business activity; indeed, even stores and stocks, the business activity's products and property held for sale to customers are not considered as capital assets, and hence the profit arising from their exchange is treated as ordinary income, the realization of other properties — e.g.; fixed assets — gives rise to a capital gain.

Well, the distinction between investments and business activities is based on the taxpayer's nature (i.e., whether it is a matter of corporate or individual business on the one hand, or of a private or non-profit body on the other) and also on the function of the property with respect to his activity.

This difference, of course, is not only important in order to apply a specific treatment for capital gains, but also in defining them: indeed, our law enumerates these profits, for income tax purposes, with the items of income, and thus reserves to them the same treatment as to all income.

In other words, the question is to establish if the profit is the product of an investment or a business activity: but, once we have ascertained that we are in this last case, this profit will be taxed, as a capital gain, according to the income tax law.

On the other hand, as regards the INVIM application the difference is not relevant, since this special tax affects all increase in value of real estates transferred or sold, whether arising from an investment or a business activity.

2. The factors relevant in distinguishing between « investment » and « business » concern only the income taxation of both individual or partnership or corporate businesses: indeed, as for private property, not used in business, the important difference is between « investment » and « speculation », as we shall discuss in more detail later on (paragraph IV, 1, *infra*). Therefore, it is a matter of circumstances which display a particular connection between the sale or exchange of a certain property and the business activity practised by the taxpayer.

Thus, the nature of property may be important, as we have already said (paragraph I, 2, *supra*) in order to establish this connection: e.g., the realization of shares (stocks) will be considered as a business activity when carried out by a holding company, and as an investment on other cases.

Moreover, there are some relevant factors in identifying the business activity, such as the frequency or number of similar transaction by the same taxpayer: if somebody, e.g., customarily invests in real estates, the real estate held by him will not be considered as a capital asset, but as a « stock in trade »; hence, the proceds of its sale do not correspond to a capital gain, but to an everyday profit.

3. At this point we must add the goodwill (*avviamento*) is considered as a business asset: therefore, the sale of an entire business, or of a branch of it, gives way to the realization, apart from all other assets used in business, of this particular intangible property too for the income tax purposes. There is, however, a special rule in the treatment of these profits, provided by art. 12 and 13 of the P.D. n. 597: when they are not itemised as part of business income, they are taxed separately, applying the average rate of the previous two years.

4. Within the capital gains relevant to income taxation our law includes gains arising from dispositions of depreciable property used in business: or rather, this is in a certain sense, as we said already (see paragraph I, 3, *supra*), the typical case of capital gain realization.

Thus, since the capital gain is considered, from the point of view at issue, as an item of income, it has to be cleared from the costs: hence, the capital gain classification is applicable only to the amount exceeding the original cost of the property, as provided by art. 5 of the P.D. n. 597, mentioned above. On the other hand, assuming as a starting point the last value assessed for taxation purposes, the excess depreciation realized upon sale of the asset is recaptured as an income, whatever depreciation method was used by the taxpayer. The same rules are applicable when the taxpayer realizes a loss on the sale of the asset, and there is no difference, for income tax purposes, between the treatment of real or personal estates.

However, when it is a matter of a real estate, INVIM applies on the basis of the objective difference between starting-value, increased by costs improvements, and realization value, without considering the depreciation, which is completely taxed.

5. Even non-depreciable assets used in business give rise to capital gain, when they are the object of a disposal: but it is required, for this purpose, that the properties concerned are « used » in the business, and not « objects » of the business, such as inventory items. On the other hand, the disposal must concern present property, hence the sale of « futures » is not considered as a realization of capital gains. Therefore, the disposition of contractual rights, book debts, accounts receivable in foreign currency, non-competition agreements etc., do not involve the capital gains treatment, although they may give rise to an extraordinary item of income.

But when an entire business is sold, or an entire branch of it, capital gains treatment applies on goodwill, as we have already said in paragraph 3, *supra*. There is, however, a difference of opinions in the case of the sale of the partnership interest by a partner.

Yet, as the shares (stocks) of a corporation are not « properties », the sale of a stock interest is not an item for capital gains treatment, unless the interest sold is such that it assures for the buyer the control on the entire corporation.

IV

1. As we have already seen (paragraph III, 2, *supra*) the distinction between « investment » and « speculation », which does not concern business taxation, is applied to non-business property. Indeed, while the realization of property used in business gives always rise to a capital gain, without distinguishing

between investment and speculation — we say, in this case, that there is a legal presumption of speculative purpose —, that of property not connected with trade or business is a source of capital gain, assimilable to an income, only when it is not a matter of simple investment, but of speculation.

The above distinction is based on art. 76 of the P.D. n. 597, and 20 of the P.D. n. 598, which provide that capital gains concur to form the income individuals and non-business entities only when arising from speculative transaction.

2. In order to define a « speculative transaction », our statute law provides few rules, the most important of which regards the holding period. This rule, however, is not generalized, but restricted to some cases. Particularly, it is provided that the sale of real estate involves a speculation when the holding period is less than 5 years. As for personal estates, the limit of the holding period is established at 2 years for works of art, antiques and elements of collections, while there is not any similar provision for other goods.

3. In the same way, the statute law specifies only a few other badges of speculation all concerning real estate. First of all, we must mention, as a factor of this distinction, the circumstances in which the property was acquired and held: the sale of real estate, provided it is sold within two years of course, is considered as a speculative transaction when the property was not destined for own personal or family use of the taxpayer; and the same rule applies to capital gains arising from sales of partnerships and stocks in companies the property of which is prevailingly invested in real estate.

In the second place, there is a speculation whenever a subdivision or urbanisation of land and a subsequent sale of it, as well as of a portion of it, were carried out.

These are the statute law rules in defining the speculative transactions, but many other factors are shown in case law, as well as in administrative practice, for cases not outlined by the statute law: e.g. the circumstances and modalities of acquisition, shall be taken into consideration, as well as the length of the period of ownership, the purpose of transaction, etc.

On the contrary, as far as INVIM goes, there is no relevant distinction between investment and capital gain, seeing that the increase in value of the real estate sold is taxed in all cases.

V

We have already seen that in business income taxation only the present properties are considered as capital assets, the disposal of which gives rise to capital gains (paragraph III, 5 *supra*). Likewise the profits from rewards of personal efforts — such as copyrights, patents, know-how, amounts received on cancellation of employments, etc. — are not important for capital gains treatment.

VI

1. For income tax purposes, profits are classified as capital gains only in the case where there occurs a non-recurrent realization of property. In our tax law there is no statutory definition of non-recurrent receipt. However, since the income arising from a disposal of property is taxable when the debt has arisen, even if it is not yet paid, we may say that non-recurrent receipts consist of a price agreed for a total sum, although its payment was effected by instalments. Instead, when the price of disposal consists of an annuity, or other recurrent amounts, we do not have a capital gain, but a « return of capital » which is considered as an ordinary income. Thus, the capital gains treatment will not apply

in the case where the price was paid in the form of royalties. In this sense, the mode of payment may be a relevant factor in determining the nature of the profit.

However, for the purpose of levying INVIM this distinction is not applicable: the increasing values of real estate which are sold or transferred are taxable in all cases.

2. It is not required, for the application of capital gains provisions, that the taxpayer shall have relinquished all his interests in the property sold: the capital gains treatment is still applicable in cases where only certain rights or interests are sold. But there is a requirement by which the disposal of these rights or interests must be *definitive* and *irreversible*, i.e. that profit from it is unreproducible in the future.

In other words, the disposal of property retaining any interest — e.g.: if a property is sold in instalments and the vendor retains a security interest in it — does not impede the capital gains treatment application. In the light of the preceding information, we may discuss some significant cases. E.g., the sale of an entire right to exploit oil in a property while retaining ownership, does not carry out a capital gains, as well as the disposal of the right to collect recurring receipts for a fixed number of years, all the more if the owner retains the balance of the rights. If all the sand and gravel from a land are sold, whether the payment is agreed in a lump sum or royyalties based on production, there is not a disposal relevant for capital gains treatment application; and the same solution will be accepted in the case where the taxpayer contracts to sell certain minerals in his land, and grants to the purchaser the absolute rights to exploit these minerals.

3. Moreover, seeing that capital gains arise from the transfer of a capital asset, whereas the reward for other people's utilisation of a property, or the availability of a sum of money, are classified as returns of capital, the receiving of a sum for can-

cellation of a long term lease, as well as the assignment for a lump-sum of the right to receive payments in the future from a lease, will not constitute capital gains. All the more so, there will be no relevance for capital gains treatment in the redemption of non-interest bearing bonds issued at a discount so that the full amounts is equal to the issue price plus interest.

Equally, the mounts received as compensation for losses or as damages are not considered as capital gains, although they are losses or damages inherent to the business activity.

As for the disposal of franchises, trademarks and tradenames, which constitute intangible assets, the capital gains treatment applies only if the price of transfer is agreed as a definite sum, even if payable by instalments, and not as a recurrent receipt.

VII

As a rule, for capital gains income taxation purposes, there is no difference in treatment between tangible and intangible assets : in both cases, as we have explained above (paragraph III, 5, *supra*), the capital gains treatment may be applied. Therefore our tax system does not provide general measures to eliminate the possibility of transforming tangible into tangicle assets, since this transformation is not important as a rule. However, particular measures are provided by statutory law on account of the few cases where transformation may be important : we have seen, e.g. (see paragraph IV, 3 *supra*) that the transfer of shares (stocks) in a company the capital of which was invested prevailingly in real estate is the same, on the holding period side and other badges of speculation, as the direct sale of these estate.

Thus, there is no qualitative difference in the treatment of the sale of a « partnership interest » if the partnership's property consists mainly of inventory items increased in value : it will influence, only the assesment of the transfer value of the interest, and not the characterisation of the disposal.

As for INVIM, tax avoiding by transferring, not a real estate, but shares and interests in companies or partnerships owning them, is avoided by the provision that these entities likewise pay the rate in question on the increased value of the properties in their ownership every ten years (D.P. n. 643/1972, art. 3).

VIII

The provisions too, regarding the transformation of ordinary income into stock appreciation, are infrequent in our tax law. That happens because these earnings, retained and accumulated as well as distributed, are, as a rule, treated in the same manner as constituting ordinary income. E.g., if a corporation has reained its earnings, they are anyway included in the total assessable profit for corporate income tax purposes; when these earnings are eventually distributed, they constitute ordinary income to the shareholder, and then they are subject, as ordinary income, to individual or corporate income taxes, according to whether the shareholder is an individual person or a partnership on one hand, or a company or corporation on other hand.

Indeed the dividends received by the residents in Italy, are subject, according to art. 27 of the P.D. n. 600, to a withholding of 10 %, as advance on personal taxes which will be due on balance by the taxpayer. There are, however, some exceptions to this: e.g., according to an amendment made by art. 20 of the Stockmarket Act, n. 237 of June 7, 1974, it has been made possible for the taxpayer to opt for a final withholding tax levied at a rate of 30 % : hence. when the dividends are so substantial, that, in the case where progressive rates are applicable to the total revenue, the balance of the tax burden would be higher than the withholding tax, this option may involve a tax sparing.

There is, however, no particular provision to avoid capital gains treatment in the case of transferring shares (stocks) in cor-

porations which accumulated their profits: indeed, seeing that in any case capital gains are included in income, such measures would be superfluous.

IX

1. As for income tax, our present law, in force since 1973, establishes the following principles.

The individual and corporate income taxes are levied, as regards resident persons or entities, according to the world-wide income principle, i.e. including in the taxable income the profits produced in foreign countries, while non-residents pay these taxes only on income produced in Italy; whereas the local income tax affects both residents and non-residents on income produced in the Republic. In order to ascertain when an income is produced in Italy or not, there are some important criteria; specifically: the business profits of non-residents are considered as produced in Italy when they arise from permanent establishments in the Republic, and this rule is available also for capital gains produced by nonresidents (art. 19, P.D. n. 597).

But in the case of a non-resident company or corporation, then the business capital gains are considered as produced in Italy, even if they do not arise from a permanent establishment, whenever they proceed from the sale of assets used in a business operating in Italy (art. 22, P.D. n. 598). As for non-business capital gains, produced by speculative transactions, they constitute income produced in the Republic when they proceed from disposals of assets situated in Italy: however, the capital gains realized by non-business foreign entities are not subject to corporate income tax.

At this point, we may now conclude that capital gains produced by non-residents are treated differently from those achieved by residents, because, while the latter are taxable, in all cases, as items' of the world wide income, the former attract a tax charge only if they arise from non-business assets in Italy, or business assets proper to a permanent establishment.

On the other hand, the residents are affected, as far as the individual or corporate income taxes are concerned, in the same way whether the capital gains are produced at home ar abroad; but not for local income tax purposes, in as much as on this side only capital gains produced in the country are taxed. Hence, while the capital gains in the country are affected by two taxes — individual or corporate income tax plus local income tax —, those arising from foreign countries are subject only to individual or corporate tax. These differences, however, do not regard the capital gains definition, but only their treatment.

As for the INVIM application, there are no particular international aspects: the tax is due whenever a real estate is exchanged, whoever is the owner.

2. The international agreements for the avoidance of double taxation and prevention of tax evasion in force between Italy and other countries concern the abrogated income taxes, but they apply provisionally to the new taxes on income (see, e.g., the Exchange of Notes between Italy and U.S.A. Ambassadors, on December 13, 1974, which establishes that the Italian Government will apply, from January 1, 1974, the provisions of the Convention signed in Washington on March 30, 1955).

These conventions, which mostly follow the O.E.C.D. Committee Draft defined in 1963, establish, as a rule, that residents of one of the Contracting States are exempt from any tax on gains from the sale, transfer or exchange of capital, in the other Contracting State, unless they have in the other Contracting State a permanent establishment and such gains are attributable to it. But on this side too it is a matter of capital gains treatment, and not a matter of definition.

X

On the basis of the preceding remarks, we may now summarize the policy of capital gains definition in our tax law.

First of all, capital gains are considered as items of total income, and hence subject to ordinary income taxes.

But capital gains arising from disposals of real estate are also affected by a special local tax, which applies income taxation independently, and thus even an increase in the value of the property is not important for income tax purposes.

As for income taxation, the capital gain is a profit arising from the disposal of a « capital asset », i.e. of a property which is not held for sale. Therefore. when the property is connected with the business or trade of the taxpayeyr, the profit is considered as a capital gain only if it arises from an investment, in as much as the profit produced by a business activity constitutes an everyday income. Thus we classify as capital gains the increase of wealth arising from the sale of depreciable business properties and of an entire businesse as well as of a partnership interest.

When an asset is not connected with a business, its disposal gives rise to a capital gain only if it was the object of a « speculation », i.e. it was originally acquired in expectation of a profit.

To sum up we may say that our law does not offer any unitary and inclusive definition of capital gains, because it takes into consideration only certain categories of capital gains; and also because the concept applies to various taxes. Indeed, there is not a specific and general tax on capital gains (see, in this sense: ROMANI, *Le traitement fiscal des gains en capital*, XLII *Cah. de Dr. Fisc. Internat.*, 96) and that enables a number of profits, which are not reducible to statutory provisions, to avoid taxation (see, on this point: ROMANI, *Gli incrementi patrimoniali e l'imposta sul reddito*, Roma, 1964). But it is necessary to recognizie that these gaps are, so to speak, « systematic » in our tax law, which is still inbued with the « income as a product » principle: hence capital gains — excepted those arising from the appreciation of real estate, liable to INVIM — are recaptured for income taxation only if they arise from a business or speculative activity.

Indeed, this principle, which was at the basis of our tax law before 1973, has been attenuated and rectified, but substantially kept in the new provisions of the Tax Reform Legislation. Thus, in order to achieve a full capital gains taxation there would have to be a radical change in our tax law, giving up the « income-product » principle and replacing it with the principle of income « as a profit », taxable independently of its source.