

Dear Audience

RE: limits on the deductibility of interest expense when determining business income.

The national legislation aims to promote the capitalization of companies by limiting the deductibility of interest expenses and similar borrowing charges. According to Article 96, paragraph 1, of the Income Tax Code, interest expenses and similar financial charges are deductible in each tax period up to a certain limit, which includes:

- A) Interest income and similar financial income for the tax period.
- B) Interest income and similar financial income carried forward from previous tax periods.

The excess interest expense and similar financial charges can be deducted up to a limit of 30% based off the Gross Operating Profit (GOP) of the core operations from the tax period and previous tax periods. For this purpose, 30% of the GOP of the tax period is used as a priority and, subsequently, 30% of the GOP carried over from previous tax periods, starting with the one relating to the oldest tax period.

Interest expenses and similar financial charges not deducted in previous tax periods, as established in Article 96, paragraph 5, of the Income Tax Code, can be deducted in the current tax period up to an amount that represents the positive difference between:

- The sum of interest income, similar financial income relating to the tax period and 30% of GOP.
- Interest expense and similar financial charges relating to the current tax period.

If the interest income exceeds the sum of the interest expense for the tax period and the ones carried over from previous tax periods, the excess can be carried over to subsequent periods.

If, in a tax period, 30% of the GOP is higher than the amount of interest expense and financial charges carried forward from previous periods, the excess portion may be added to the GOP of the five subsequent tax periods.

Gross Operating Profit Calculation

On the assumption of the possibility of any excess interest expense and similar charges compared to income and similar income, it is deductible within certain limits, the amendments,



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introduced by Article 1 of Legislative Decree 142/2018, which redefined Article 96 of the Income Tax Code, affect the determination and use of GOP with the following variations:

- intake of a "fiscal" GOP instead of an "accounting" GOP;
- inclusion in the calculation of GOP of the positive and negative components of extraordinary income deriving from transfers of business or business units, previously excluded from the law;
- limitation carrying-over GOP surpluses formed from the 2019 tax period, within the fifth tax period following the one in which such surpluses were formed;
- priority for the use of GOP by giving priority to that of the current year and, subsequently, to that resulting from previous tax periods, starting from the oldest tax period.

In addition, GOP "of core operations means the difference between the value and costs of production referred to in Article 2425 of the Civil Code, letters A) and B), with the exclusion of the items referred to in number 10), letters a) and b), and the financial lease payments of capital goods, assumed to the extent resulting from the application of the provisions aimed at determining business income. For entities that prepare the financial statements in accordance with international accounting standards, the corresponding income statement items are assumed".

As specified in point 2 of Article 96 of the Income Tax Code, the excess of interest expense and similar financial charges with respect to the total amount of interest income and similar financial income is deductible up to the amount resulting from the sum of 30% of the GOP of core operations for the fiscal year and 30% of the GOP of core operations carried over from previous fiscal years.

For this calculation, 30% of the GOP of core operations for the fiscal year is used first, and then 30% of the GOP of core operations carried over from previous fiscal years, starting with the oldest fiscal year.

In practice, after using the GOP of the fiscal year, a "FIFO" criterion is applied, which implies the priority use of the GOP surplus accumulated in the oldest fiscal year.

Considering that paragraph 7 of Article 96 of the Income Tax Act establishes that if, in a tax period, 30% of the GOP of core operations is higher than the excess and the amount of interest expense and similar financial charges carried over from previous tax periods, the excess amount can be added to the GOP of the five subsequent tax periods.

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The "accounting" GOP in excess at the end of the tax period in progress as of December 31st 2018 is no longer transferable to the following year, unless the transitional regime is applied.

This regime provides, among other things, that starting from the tax period following the one in progress on December 31st 2018, interest expenses and similar financial charges, deriving from loans contracted before June 17th 2016 and not modified as a result of contractual changes, are deductible for an amount equal to the sum of 30% of the GOP generated starting from the third tax period following December 31st 2007 and not used for the deduction of interest expenses and financial charges, according to the provisions of Article 96 of the Income Tax Act in its formulation prior to the amendments, and the deductible amount according to the new provisions of Article 96 of the Income Tax Act.

It is the same paragraph 3 of Article 96 of the Income Tax Act that identifies the interest income and expenses subject to limitations in terms of deductibility. Interest income and expense, must meet the following conditions at the same time:

- Be recognized as such according to the accounting principles adopted by the company;
- Be qualified in accordance with the tax coordination provisions applicable to national and international accounting standards;
- Arise from a transaction or contractual relationship with a financial cause, or from a contract that includes an important financing component.

In the case of a company that applies the amortized cost method, costs defined as "transaction accounts", such as commissions, legal fees, professional services and other costs related to the transactions carried out, must also be considered as interest.

Finally, paragraph 15 of Article 96 of the Income Tax Act clearly states that "the priority application of the rules of absolute non-deductibility provided for in Article 90, paragraph 2, and Article 110, paragraph 7, of this consolidated law and Article 1, paragraph 465, of Law No. 311 of December 30th 2004, on interest on loans of members of cooperative societies remains unaffected".

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