ITALY MODERNIZES TAX TREATMENT OF L.B.O. TRANSACTIONS

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On March 30 2016, the Italian Revenue Agency issued the Circular Letter No. 6/E (the "Circular Letter"), which confirms the characterization of a Leveraged Buyout ("L.B.O.") from a tax perspective and addresses certain tax issues that typically arise from this type of transaction. The Circular Letter was designed to create a favorable environment for foreign investment in Italy and to reverse negative publicity arising from interpretative uncertainty over tax consequences.

In this respect, the Circular Letter provides important clarifications concerning

- the deductibility, for corporate income tax ("C.I.T.") purposes, of interest expense incurred in connection with acquisition loans and shareholder loans;
- the appropriate tax treatment, for C.I.T. and V.A.T. purposes, of transaction costs and other fees charged by private equity firms to a target company ("Target") and/or acquisition company ("Bidco"); and
- the taxation of capital gains realized at exit and the reduction of withholding tax on outbound dividends under an applicable Double Tax Convention ("D.T.C."), E.U. directive, or provision of domestic law.

INTEREST DEDUCTIBILITY

Over the past few years, the deductibility of interest incurred in connection with mergers of L.B.O. acquisitions has been challenged by the Italian tax authorities. The typical argument in these matters may be summarized as follows:

- The interest expense was not linked to borrowings incurred in the course of the business activities of Target.
- The L.B.O. transaction was simply a tax-driven transaction involving the pushdown of debt in order to obtain a tax advantage from the resulting interest expense, thereby reducing Italian tax on Target's cash flows.
- In transactions involving foreign investors mainly, the borrowing was not made for business reasons in Italy. Rather, it was incurred at the direction of the ultimate controlling shareholder. This leads to a contention that the borrowing is a form of service rendered by the acquired company for the benefit of the controlling foreign shareholder. The service must be compensated with an arm's length fee, which happens to be equal to the interest deduction.

Breaking with the past, the Circular Letter clarifies that, as a general principle, deductibility of interest on the acquisition loan should be allowed, subject only to ordinary limitations, which include a cap that is approximately 30% of earnings before interest, taxes, depreciation, and amortization ("E.B.I.T.D.A."). In addition, a more

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reasonable transfer pricing rule is applied by Italian Revenue Agency. On the basis of the Circular Letter, the revised treatment is as follows:

- Interest expense borne by a company set up to accomplish the acquisition (either a special purpose vehicle (“S.P.V.”) or an existing Bidco) is recognized as being functionally connected to the purchase of Target. Therefore, the deduction of interest expense on third-party debt should be allowed either in the case that the transaction is concluded with (i) the merger of S.P.V./Bidco and Target or (ii) the creation of a fiscal unity between S.P.V./Bidco and Target.

- L.B.O. transactions are recognized as being grounded on sound economic reasons, as they are aimed at acquiring control over Target and this structure (including the debt push down) is usually requested by third-party lenders. Therefore, the leveraged transaction should not be regarded *per se* as abusive. The transaction should only be viewed as abusive when the operation is intended to obtain an undue tax benefit that is contrary to the spirit and objective of the law. An example would be a re-leveraged transaction without a change of control.

- The contention that S.P.V./Bidco acts for the benefit of its ultimate foreign controlling company has been abandoned. On the contrary, following the O.E.C.D. Transfer Pricing Guidelines, if the foreign parent company raises funds on behalf of the subsidiary that uses those funds to acquire a new company, the parent company would generally be regarded as providing a service to the subsidiary for which remuneration would be requested. This could justify the deduction of a service fee (in addition to interest) at the level of the subsidiary.

Based on the new guidelines, the Italian Tax Authorities may decide to reconsider earlier tax assessments and pending litigation that are based on legal claims that debt pushdowns are generally abusive. This reassessment would not include instances in which the transaction was specifically aimed at creating an artificial interest expense deduction, which may be the case with re-leveraged transactions within the same group.

SHAREHOLDER LOANS

The Circular Letter explains that interest expense incurred by S.P.V./Bidco on loans granted by foreign shareholders is subject to transfer pricing rules that apply the arm’s length principle. Under exceptional circumstances, shareholder loans may be recharacterized as capital contributions where the facts so indicate. For example, an abusive transaction may be presumed to exist if one or more of the following situations occur:

- The reimbursement of the shareholder loan and the payment of the interest are subordinate to payment of loans/interests to third-party lenders.

- The ratios provided under the financial covenants do not consider the shareholder loan as debt and interest accrual as an expense (as opposed to equity).

- The payment of the interest and principal are subject to the same restrictions imposed on dividends distributions and capital reductions.

- In general terms, the shareholder loan and the accompanying interest expense are characterized by lenders as if they are equity capital and dividends.

If recharacterized, the following consequences arise:

- Interest expense accruals on shareholder loans are not deductible.
- Interest payments made in respect of shareholder loans may be subject to withholding tax as dividends.
- The Allowance for Corporate Equity ("A.C.E.") benefit – *i.e.*, a deduction of a notional return equal to 4.5% of the increase in equity – should increase (but specific anti-abuse rules should be considered in order to quantify the benefit).

The Circular Letter states that, in respect of past situations, administrative penalties should be waived since taxpayers have been misled by the interpretative uncertainty of the relevant law.

CORPORATE TAX TREATMENT OF FEES

The Circular Letter states that advisory fees (such as transaction or monitoring fees) charged by a private equity firm may be deducted by Target as long as an economic benefit is derived from the services received. In comparison, fees for services that are provided for the benefit of the investors but paid for by Target are not deductible by Target. Identifying the benefitting party is a factual exercise and all facts and circumstances surrounding the payment must be examined.

The following factors may indicate that advisory fees are paid for services that do not benefit Target:

- Fees paid by Target offset some or all of the management fees due by the fund.
- The amount of the fees paid to the private equity firm or advisory firm exceeds an arm's length amount that is customary for the types of services rendered.
- Payment of the fees is tied to the same limitations provided for dividend distributions to the private equity firm.
- Where the portfolio company is acquired by a consortium of private equity funds, fees charged by the various advisory firms are in proportion to the shareholdings of each private equity firm.

V.A.T. TREATMENT OF FEES

The Circular Letter states that, if S.P.V./Bidco is a passive investor that does not participate in the management of Target, input V.A.T. on various transaction costs may not be recovered by the S.P.V./Bidco used to effect the transaction or a successor company created through a merger with Target ("Mergerco"). In addition, Target is not entitled to recover V.A.T. on services provided for the benefit of the investor group.

EXIT TAX TREATMENT OF CAPITAL GAINS AND DIVIDENDS

Capital gains realized by a foreign S.P.V. that directly holds the shareholdings in the Italian Mergerco or Bidco are taxed at exit as follows:

- Under domestic rules, capital gains realized by non-Italian resident entities are taxable at an effective tax rate of approximately 14%.
- Capital gains realized by white-listed resident entities upon the disposal of a non-substantial shareholding (capped at 20% of voting rights or 25% of share capital) of an unlisted company are exempt from tax.
- Capital gains realized by foreign entities upon the disposal of a non-substantial shareholding (capped at 2% of voting rights or 5% of share capital) of a listed company are exempt from tax.
- Pursuant to Article 13 of a D.T.C. based on the O.E.C.D. Model Tax Convention, capital gains derived from the sale of shareholdings are taxable only in the state of residence of the shareholder.

EXIT TAX TREATMENT OF DIVIDENDS

Dividend distributions from an intermediary Italian holding company that owns shares of Target are taxed at exist as follows:

- Dividends are subject to ordinary withholding tax (currently 26%), which may be reduced pursuant to an applicable D.T.C.
- Dividends distributed to an E.U. parent company may benefit from full exemption from Italian withholding tax under the E.U. Parent-Subsidiary Directive (the "P.S.D."), as implemented in Italy.
- If outbound dividends do not qualify for full exemption under the P.S.D., the E.U. parent company may, in principle, claim the benefit of a reduced withholding tax rate of 1.375%.[1]

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LIMITATION ON EXIT TAX BENEFITS

According to the Circular Letter, where the fund is established in a country that does not allow for adequate exchange of information, the intermediary E.U. holding company will not be entitled to tax relief when it does not have sufficient economic substance. In the absence of substance, the intermediary holding company is viewed as having been artificially created to take undue advantage of the benefit provided for in the P.S.D. and/or D.T.C.'s as well as domestic rules that reduce the tax burden on exit.

In the absence of economic substance, an intermediary entity is deemed to have been artificially set up as mere a conduit to its beneficial owner. A non-Italian entity may be viewed as lacking economic substance where the following conditions are met:

[1] D.P.R. 600/1973, art. 27, para. 3-ter.

- It has a light organization. For example, it does not have full-time employees on its staff and does not have offices and equipment other than those made available by third-party companies through management service agreements. It does not carry out real economic activity, or it has little or no discretion in the decision-making process of its business.
- It does not carry out real economic activity, or it has little or no discretion in the decision-making process of its business.
- It acts as a mere financial conduit in the context of a specific arrangement involving receipts and disbursements that are symmetrical in terms of amount and timing and are not subject to further withholding tax in the state of residence.

If the fund is established in a blacklisted country and the intermediary holding company would be disregarded based on the above arguments, capital gains realized upon the disposal of Target's shares would be subject to tax in Italy and outbound dividends from Italy would be subject to ordinary withholding tax, as if the fund invested directly. Nonetheless, when the fund is set up as a transparent entity, treaty benefits may be claimed directly by the ultimate parent fund's investors under certain circumstances.

WHITE LIST

The above-mentioned limitation deals only with investments made by funds established in blacklisted countries through an E.U. holding company. It should not apply when the fund is located in a country allowing for an adequate exchange of information (a so-called whitelist country) that is also in compliance with E.U. principles.

Countries allowing for adequate exchange of information are currently listed in Ministerial Decree 4 September 1996. This legislation was issued pursuant to Legislative Decree No. 239/1996, which sets the rules for taxation of interest on bonds and similar notes from Italian issuers. Legislative Decree No. 147/2015 introduced recent changes and stated that the white list should be rewritten and updated by ministerial decree every six months, so as to include all the (new) countries that meet the requirements in the intervening time and are therefore considered whitelisted.

In 2015, a number of Tax Information Exchange Agreements ("T.I.E.A.'s") were ratified by the Italian government, including an agreement with the Cayman Islands, Guernsey, and Jersey. Following these developments, and considering the level of actual cooperation attained with regard to exchange of information, there is no longer justification for countries having T.I.E.A.'s with Italy to be excluded from the white list. Therefore, even before a new list is formally issued, it is reasonable to treat these countries as whitelisted.