CIRCULAR LETTER NO. 25/E CLARIFIES ITALY'S NEW CARRIED INTEREST REGIME

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INTRODUCTION

On April 24, 2017, the Italian government introduced a new tax regime addressing carried interests and similar arrangements that involve shares, quotas, and other financial instruments. The aim is to boost the Italian private equity and private debt sectors and make Italy more attractive to fund management companies and top executives.

The new regime has been introduced by Law Decree 24 April 2017 No. 50 (the "Decree"),[1] which provides that "qualifying" carried interest schemes are deemed financial income, rather than employment income. Article 60 of the Decree provides an irrebuttable presumption that remuneration derived from certain carried interest schemes qualifies as income from capital, or capital gain, generally subject to only a 26% substitute tax.

On October 16, 2017, the Italian tax authorities released official guidelines, Circular Letter No. 25/E (the "Circular"), that provide significant clarifications on the scope, requirements, and conditions envisaged under the new tax regime.

CARRIED INTEREST: AN OVERVIEW

Private equity transactions generally require a contract between investors and the fund managers that includes provisions exposing the managers in investment-related risks.

One of these mechanisms is the "carried interest," a compensation incentive that aligns the interests of the fund managers with those of the investor group. This kind of remuneration takes the form of shares, quotas, or financial instruments with "enhanced economic rights," such as

- a shareholding more than proportional to the profits of the investment, or
- the right to convert financial instruments into a more than proportional number of ordinary shares.

This is achieved by tying remuneration to a minimum return for other investors.

QUESTION OF INCOME CLASSIFICATION

The dual role of the manager as administrator or employee and shareholder has created questions regarding the tax treatment of carried interests. If the income

[1] Converted into Law 21 June 2017, No. 96.

from enhanced equity rights is classified as financial income, the managers may benefit from the flat rate of 26%, as mentioned above. On the other hand, if that income is classified as employment income, it can be taxed at marginal rates up to 43% plus local surcharges and social contributions.

The core issue is that some types of carried interest typically are considered to be performance fees, which fall within the category of employment income if viewed as a bonus for performance. According to Article 51 of the Italian Income Tax Code ("T.U.I.R."), employment income consists of "*all sums and values of whatever nature received during the tax period, . . . , in relation to the employment relationship*." To that end, Ministerial Circular No. 326/1997 clarified that all remunerations related to an employment relationship are properly categorized as employment income "*even if they are not directly paid by the employer*," including "sums and values received in the form of equity shareholding."

One area of concern is where the rules apply to stock options. Pursuant to Italian law, income arising from the exercise of stock options (calculated as the difference between the fair market value of shares purchased and the strike price) is considered employment income. This definition posed problems for managers who benefit from:

- a "preferential" distribution of the company profits or a capital gain realized through the disposal of the company itself, or
- in the case of stock options, the payment of a strike price lower than the market value of the shares.

The similarity between the carried interest and stock options regimes led to uncertainty regarding the treatment of carried interest for income tax purposes.

In 2012, the Italian tax authorities addressed the classification of this kind of compensation in Resolution n. 103. The case concerned the assignment of a disproportionate number of shares to the company's managers compared to their cash investment in the company. The Revenue Agency stated that the non-proportional allocation of the shares to the managers had, in the analyzed case, a remunerative function for their performance. Consequently, the income arising from the share assignment – equal to the difference between the total fair value of the shares assigned to each manager and the amount paid to subscribe them – is to be considered employment income. This conclusion reflected the following rationale:

- The impossibility for the managers to transfer their shares to third parties until a specific holding period
- The connection between the share assignment and the work provided by the managers

Nonetheless, the Revenue Agency clarified that any income such as dividends and/or capital gains attributable to managers as a result of the ownership of the shares acquired through the non-proportional assignment maintains the character of "financial income" as "*the participation to the profits is not subject to the existence of the employment relationship, since the beneficiary could maintain the shares even if the work relationship is terminated*."

Consequently, the classification of the income received from the shareholding under

Article 44, para. 1, let. e of T.U.I.R. (*i.e.*, dividends from shareholding) does not depend on whether a work relationship exists between the recipient of the profits and the distributing company.

The fact that the characterization as "financial income" does not depend on the existence of an employment relationship raises the same questions regarding the loss of enhanced economic rights due to departure clauses.

NEW RULES ON CARRIED INTEREST

Given the uncertainty of this situation and a desire to attract high-skilled individuals and capital to Italy, the Italian government introduced a new provision laying down the conditions under which carried interest is to be considered financial income and not employment income.

With Art. 60 of the Decree, the Italian government introduced new rules that address proceeds derived from direct or indirect participation in companies, entities, or collective investment undertakings that are represented by shares, quotas units, or other financial instruments granting enhanced economic rights ("eligible instruments").

Under the new regime, if certain conditions are met,

- income and gain derived from direct or indirect participations in companies, other entities, or collective investment undertakings ("C.I.U.'s") established in Italy, or in a jurisdiction allowing for adequate exchange of information with Italy (*i.e.*, "white list jurisdictions"),
- will be deemed to constitute investment income (generally taxed at 26%), rather than income from personal services (taxed at progressive rates up to 43% plus surcharges)
- when received by employees and directors ("Managers") of such companies, investment undertakings ("relevant funds or companies"), or other persons controlling or managing such companies (*e.g.*, employees and directors of the management company of an investment fund).

Those eligible for the incentive include managers and employees of advisory companies, investment companies, and target companies. In this regard, it should be noted that advisory companies are included within "eligible persons" since they have a key role in investment strategies, although they have no investment decision ability and therefore no direct responsibility. On the other hand, excluded persons consist of professionals such as lawyers acting as consultants.

The application of the special regime is subject to three conditions:

- *1% Investment Threshold.* The actual investment made by all managers requires an effective disbursement greater than or equal to 1% of the total investments of the relevant fund or company.
- *Repayment Subordination.* The proceeds from shares, quotas, or financial instruments are only payable once all the fund investors or company shareholders have received an amount equal to the invested capital plus a minimum yield (*viz.*, a hurdle rate) set out by the fund regulations or by law.

- *Holding Period.* The relevant shares, units, and financial instruments must be held for at least five years or, if earlier, until the date of a change of control of the relevant company or entity, or a change of the management company of the collective investment undertaking.

Before analyzing the above conditions, it should be highlighted that the new regime concerns only proceeds derived from the holding of financial instruments with special economic rights. It does not apply to income derived from the financial instrument assignment. Indeed, upon assignment (*i.e.*, subscription or acquisition) of any eligible instruments, the excess in value between the fair market value of shares, quotas, or financial instruments and the actual amount paid will be treated as a benefit in kind and taxed as employment income. Such income is taxed at progressive rates of up to 43% on taxable income exceeding €75,000.

"The new regime applies to carried interests if all the other fund investors or shareholders other than the holders of the carry have received an amount equal to the invested capital hurdle."

1% Investment Threshold

The Circular clarifies two points with regard to funds.

First, the Managers' 1% total investment is represented by the effective capital invested, which also takes into consideration financial instruments other than those with enhanced economic rights and securities (with or without enhanced economic rights) ascribed to Managers as fringe benefits and taxed in their hands as employment or self-employment income. Considering that the Decree makes reference to direct or indirect participations in eligible instruments, where financial instruments with special economic rights are held through a dedicated company or trust or subscribed by a management company in which the holders of the carry participate, the indirect participation will be counted for the purposes of the 1% threshold.

Second, the overall investment made by the relevant fund is determined with reference to the amounts the fund has effectively received from investors (*viz.*, drawdowns), including management fees, and net of any third-party debt. In other words, the carry holders' disbursement must be proportional to the capital actually invested by the other investors, rather than to the amounts employed to acquire the underlying investments, which usually include substantial financing.

The Circular also clarifies that the 1% threshold must be verified at the end of the subscription period. Once the 1% threshold is exceeded, further transfers of the same securities with special economic rights to a person other than an employee or director (*e.g.*, by means of succession) will not trigger any consequence for the remaining carry holders even if the overall interest falls below 1%. The same conclusion can be achieved in a case where the manager terminates his or her employment relationship. Clearly this is not effective where an abuse of law exists, such as would be the case where all steps are part of a prearranged plan.

The Circular also provides useful comments on the application of the Decree when the eligible instruments are issued by a company instead of a collective investment vehicle. With regard to companies, the minimum threshold requirement must be commensurate with the company's net equity, to be calculated at fair market value determined through a specific appraisal. Furthermore, to meet the 1% investment condition, the Managers' investment must be adjusted to account for any further investment in the company by other investors.

The Circular also specifies that the foregoing condition is not met if the financial instruments are acquired by the Mangers through loans granted by the employer or third parties under favorable conditions. Where that occurs, there is no alignment between the interests of the Managers and those of the investors. In contrast, the condition is met if the financial instruments are subscribed through loans granted at rates lower than market standards provided that the loan granted in connection to the employment relationship is treated as benefit in kind pursuant to Art. 51, para. 4 of T.U.I.R.

Repayment Subordination

The Circular clarifies that the new regime applies to carried interests if all the other fund investors or shareholders other than the holders of the carry have received an amount equal to the invested capital hurdle.

If the repayment subordination condition is met, the new regime is applicable to both reimbursements and disposals of eligible instruments.

Only the carried interest must be subordinated in order to satisfy the regime.

Holding Period

A minimum holding period of five years must be met, during which all financial instruments held by Managers comprising the 1% investment threshold must be held. Hence, the holding period requirement also applies to ordinary units or interests issued by C.I.U.'s, companies, and entities and held by all carry holders. If a securities disposal occurs before the five-year period ends, the regime will not apply.

The Circular clarifies that the five-year holding period will be determined starting from the end of the subscription period for C.I.U.'s or on the date of subscription of the capital injection for entities other than C.I.U.'s.

In the event of the death of the employees or administrators, the balance of the five-year holding period requirement must be met by the heirs. Moreover, in the case of a securities disposal that triggers a "change of control" during the five-year holding period, the carried interest regime continues to be applicable. However, in the case of a transfer of the units or interests within the five-year period, such as by a change in members of the management team, a new holding period begins from the date of the change of ownership.

The holding period condition does not mandate that the distribution of carried interest proceeds be deferred until the end of the holding period. Indeed, the carried interest can be effectively received by the Managers within the five-year holding period provided that the financial instruments are held for the minimum period required.

OTHER CLARIFICATIONS

If all the foregoing requirements are met, the income received by the Managers is treated as financial income, irrespective of any connection to employment activity provided to the company, entity, or C.I.U. (or to related or controlled entities). On the other hand, if the conditions are not met, the carried interest is not automatically treated as employment income for tax purposes.

The Circular also provides important comments on the treatment of carried interest proceeds in the case any of the conditions are not met. In particular, it clarifies that

carried interest could continue to be treated as financial income provided that it is not actually used to remunerate an employment or self-employment activity carried out by the Manager and highlights facts to consider when classifying the carried interest as employment income or financial income. For such purposes, a carried interest may generally fall within the category of financial income if the following facts are present:

- Managers' interests are aligned with investors' interests
- Managers bear the actual risk of loss of the invested capital
- Managers and other investors hold the same financial instruments with special economic rights (*i.e.*, securities with special economic rights are not reserved to Managers)

In contrast, the carried interest may be classified as employment income where the following facts are present:

- Arrangements exist distinguishing between good departures, such as termination other than for cause, and bad departures, such termination for cause or early resignation, unless they are mitigated by other circumstances.
- Managers' investment risks are neutralized (*e.g.*, clauses that guarantee Managers total reimbursement of invested capital).
- Managers receive compensation below market standards.

The Circular clarifies that the possibility for the holders of the carry to retain ownership of the units or interests even after a departure may be considered sufficient proof of the financial character of the instrument, even if none of the conditions set by the Decree are met.

In any case, under such circumstances, the carry holders may submit a ruling request to the Italian Tax Authorities in order to confirm the tax treatment of their carried interest schemes.

The new provisions apply to income realized on or after April 24, 2017. Investment plans approved as of April 24, 2017, may be amended in order to benefit from the new rules.