



STUDIO
LEGALE E TRIBUTARIO

AIFI

Italian Private Equity, Venture Capital
and Private Debt Association

A hand in a dark suit sleeve is drawing a white line graph on a whiteboard. The graph features a solid line with a sharp upward curve and a dashed line with a jagged, fluctuating path. The background is a blue-tinted image of a whiteboard with various data points and lines. On the left side, there is a vertical axis with numerical labels: 10000, 8000, 6000, 4000, and 2000. The overall scene is brightly lit, creating a professional and analytical atmosphere.

DOING PRIVATE EQUITY IN ITALY

The Tax Perspective



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DISCLAIMER

This document is intended to be of general interest and does not constitute professional advice.

The information provided in the present document is referred to subjects of general interest and shall not be considered a full and complete disclosure of the issue under discussion.

The application and effect of the law may differ widely depending on the case at hand. Before starting any legal proceedings, it is recommended to look for a personalized and appropriate professional advice.

This document has been prepared in June 2016, therefore it is based on the legislation today into force and on the information available at the time of its drafting.

SCOPE OF THE WORK

This work aims at providing general insight into the main instruments and opportunities available to foreign investors wishing to do business in Italy particularly through Italian private capital funds. In particular, this work is intended as an introductory guide for foreign investors to the main tax issues they will most likely encounter upon deciding to invest into Italian companies.

This booklet is divided into 5 chapters.

The first chapter provides a brief overview of the most common legal structures used by Italian private capital funds.

The second chapter aims at describing the tax treatment of (I) the Italian private capital funds and (II) foreign investors' profits realized through investment in Italian private capital funds.

The other three chapters show the Italian tax system focusing on Italian company taxation and deal structuring. More in details,

the third chapter provides a brief overview on the main taxes, both direct and indirect, that generally apply to corporate taxpayers in Italy. The fourth chapter contains a brief overview on common investment schemes that can be used by private equity investors when structuring their acquisition, considering that the investment is usually structured as follows:

- **Step 1:** purchase of an Italian intermediate company ("BidCo");
- **Step 2:** funding of BidCo;
- **Step 3:** acquisition of target;
- **Step 4:** post-closing phase;
- **Step 5:** exit phase.

The fifth chapter aims at providing a general overview of Italian main management incentive schemes with reference to Italian residents (cash bonus, SOP, attribution of special class of shares or warrants).

ACRONYMS

CL Circular letter issues by Italian Tax Authorities

DTT Double taxation treaty entered into force in Italy

IRES Italian corporate income tax introduced by Presidential Decree 917/86

IRAP Italian regional income tax provided by Legislative Decree 446/97

ITC Italian Tax Code provided by Presidential Decree 917/86

GOI Gross Operating Income

LBO Leveraged Buy-Out

NID Notional interest deduction (*i.e.* “ACE”)

TA Italian tax Authorities

TC Transaction costs occurred during the acquisition

VAT Value added tax

WHT Withholding tax

ITALIAN PRIVATE CAPITAL FUNDS FRAMEWORK

1.1 THE LEGAL STRUCTURES USED BY ITALIAN PRIVATE CAPITAL FUNDS

This chapter provides a brief overview of the most common legal structures used by Italian private capital funds.

Following the implementation of Directive 2011/61/UE on alternative investment fund managers (AIFMD) that introduced a harmonized regulatory framework over the rules applicable to alternative investment fund managers (AIFMs) of alternative investment funds (AIFs), the most common legal structures used by Italian private capital funds are:

- SGR
- SICAF

SGR

The most common legal structures used by Italian private equity funds are the closed-end investment schemes for investing directly or indirectly (through holding companies) into private compa-

nies. Usually, a management company (“SGR”), responsible for the establishment, the investment management decisions and the administration of funds, manages them. The main characteristics of the closed-end investment funds are:

- separation between funds and management company, in order to secure a faster investment choice;
- duration of the fund that allows investors to achieve results within a short time period;
- fund’s closed end term that allows investors to exit from the funds at specific times.

Investment funds set up by SGR are similar to common law schemes (as partnership managed by a regulated management company) even if SGR are more strictly regulated.

SICAF

The Legislative Decree no. 44, of March 4th 2014, implementing the AIFMD, introduced a new form of collective investment, the fixed-capital investment companies (SICAF), that may be also used to set up private equity investment vehicles.

A SICAF is a closed-end investment company organized in the form of a joint-stock company subject to the same provisions applicable

CLOSED-END FUNDS

- separation between funds and management company, in order to secure a faster investment choice;
- duration of the fund that allows investors to achieve results within a short time period;
- investors can exit from the funds at specific times.

SICAF

- established as a joint-stock company and registered offices in Italy;
- corporate purpose must be limited to the collective investment;
- shareholders should have certain good standing requirements.

under the Italian law to closed-end investment funds. It can be managed by a board of directors or by an external management company (such as an SGR).

The main characteristics of SICAF are:

- it must be established as a joint-stock company with administrative and registered offices in Italy;
- its corporate purpose must be limited to the collective investment of the capital collected through the issue of shares or participating financial instruments;
- SICAF shareholders should have certain good standing requirements. The directors and statutory auditors must satisfy certain professional and independence requirements.

Both SGR and SICAF represent the legal structures used to set up investment vehicles.

1.2 DIFFERENT TYPES OF INVESTMENT FUNDS

The different types of investment funds most commonly established are: private equity, venture capital and private debt funds.

1.2.1 PRIVATE EQUITY FUNDS

Private equity funds are investment funds with a specific focus on development, growth, buy out and turnaround operations.

1.2.2 VENTURE CAPITAL FUNDS

Venture capital funds are investment funds focused on start-up and small-medium-size enterprises with strong potential growth. These invest-

ments are generally characterized as high-risk/high-return opportunities. In addition to business angels, equity crowdfunding and other seed funding options, venture capital is attractive for new companies with short operational experience, too small to raise capital in public markets and unable to secure bank loans. In return for the high risks taken when investing in small and less mature companies, venture capitalists usually get significant control over company decisions, in addition to a significant portion of the companies' ownership (and, consequently, value).

1.2.3 PRIVATE DEBT FUNDS

Debt funds are funds that offer flexible debt instruments like bonds, loans, convertible debt instruments, shareholding instruments of debt, in relation to the requirements of each stock company. Using private debt funds, an Italian stock company could:

- optimize its financial structure, for example replacing its short term debt with a medium long term debt (or bond), refinancing its medium-long term debt and the relevant expiry date;
- increase its contractual power towards bank system, clients and suppliers;
- find stable financial partners.

Usually, private debt funds require some guarantees such as share pledge and mortgage.

The products offered by private debt funds are different to the ones offered by private equity funds: in fact, private debt funds invest in debt capital while, on the contrary, private equity funds invest in equity. A debt fund provides a steady, but low income in relation to equity. Moreover, private debt funds and private equity funds invest in complementary rather than competitive markets.

FISCAL TREATMENT OF ITALIAN PRIVATE CAPITAL FUNDS

This chapter provides a brief overview of the tax treatment of (I) the Italian private capital funds (including Italian AIFMs provided with an AIFMD passport) and (II) foreign investors' profits realized through direct or indirect investments in Italian private capital funds.

2.1 ITALIAN PRIVATE CAPITAL FUNDS TAXATION

From a legal point of view, Italian SICAF, SICAV and Italian investment funds are defined as Italian OICR, pursuant to article 1, paragraph 1, letter l), of Decree 24 February 1998, no. 58 ("TUF"). According to article 73 of Presidential Decree no. 917 of 22 December 1986 ("ITC"), Italian investment funds are deemed to be resident in Italy for income tax purposes and they are liable to the Italian corporate income tax ("IRES").

The ITC also establishes that proceeds realized by Italian investment funds are exempt from Italian income taxes. Consequently, proceeds realized by funds from investments (dividends or capital gains) shall be received gross of any Italian withholding tax or substitute tax and shall not be subject to the Italian income taxes.

Based on the wording of the ITC, and according to the interpretation of the Italian tax authorities, investment funds are entitled to the application of the Double Tax treaties, entered into force in Italy. The SGR, in the name and on behalf of the funds, could require the issuance of the tax residence to the certificate Italian tax authorities.

SICAF is subject to the Italian regional tax on productive activities ("IRAP") according to articles 3 and 6 of Decree 15 December 1997, no. 446.

Private equity, venture capital and private debt funds are not subject to IRAP.

2.2 ITALIAN TAX TREATMENT FOR FOREIGN INVESTORS OF ITALIAN PRIVATE CAPITAL FUNDS

The tax treatment of proceeds arising in the hands of the funds' investors depends on both the type of proceeds and investors as well as on investor's tax residence.

TAX TREATY

Investment funds are entitled to the application of the Double Tax treaties

TAX EXEMPTION

Proceeds realized by Italian investment funds are exempt from Italian income taxes

WHITE LISTED FOREIGN INVESTORS

No WHT occurs if:

- the recipient is resident in a country an adequate exchange of information
- an “institutional investors” established in white listed foreign investors
- (others)

OTHERS FOREIGN INVESTORS

26% final WHT

White listed foreign investors

Both in case of capital income and capital gains realized through the sale of units, no taxation occurs if the recipient does not have any Permanent Establishment in Italy and:

- for tax purposes, the recipient is resident in a country that grants Italy an adequate exchange of information (and is the beneficial owner of the income); or
- is an “institutional investors” established in white listed foreign investors; or
- is an international entity or body set up under international agreements in force in Italy; or
- is a central bank or organization managing official State reserves.

An institutional investors could be: (I) an entity subject to regulatory supervision in the state in which it is incorporated; or (II) an entity, including tax transparent entities, not subject to regulatory supervision which has a specific expertise in financial instruments investments; or (III) an entity, including tax transparent entities, not subject to regulatory supervision, which has been set up with the sole purpose of managing investments for institutional investors subject to regulatory supervision, provided that both the institutional investors and the manager are tax established in white list countries.

Other foreign investors

A 26% final withholding tax is levied by the SGR on capital income, whilst a 26% substitutive tax is due on capital gains.

ITALIAN TAX SYSTEM

This chapter provides a brief overview of the main taxes, both direct and indirect, that generally apply to corporate taxpayers in Italy, as well as on foreign institutions investing in Italian companies either directly or through the AIFMD passport.

3.1 DIRECT TAXATION

3.1.1 CORPORATE INCOME TAX (“IRES”)

Corporate taxpayers (e.g., Italian joint-stock companies - “S.p.A.” – and limited liability companies - “S.r.l.”) are liable to corporate tax (so-called “IRES”) in Italy at a 27.5% rate. Following recent approval by Parliament of Budget Law for fiscal year 2016, the rate will be reduced from 27.5% to 24% starting from January 1st, 2017.

As a general rule, corporate taxpayers who are resident in Italy according to Italian tax law (*i.e.*, having their registered office, place of management or main business in the country for the greater part of a fiscal year) are liable to IRES on their overall income, regardless of its sources (*worldwide taxation principle*).

In general, business income is taxable and expenses are deductible upon accrual. However, an item of income or an expense of uncer-

tain timing or amount, shall only be taxable/deductible in the fiscal year when it becomes certain. Tax losses of a fiscal year may generally be carried forward (with no time limitation) to future fiscal years and used to reduce up to 80% of taxable income of each fiscal year.

Exemption on dividends and capital gains.

A 95% exemption is generally available on dividends received by other companies (e.g., a subsidiary), provided they do not pertain to a participation in a resident of a “tax haven”, *i.e.* non-EU countries with (ordinary or special) tax regimes, where nominal corporate tax rates are at least 50% lower than the Italian one.

The same 95% exemption also generally applies to capital gains arising from disposal of shares or interests in other companies, provided that the following conditions are all met:

- shares/interests are held for a minimum holding period of 12 months;
- shares/interests are recorded as “fixed financial assets” (according to Italian GAAP) or as financial assets not “held for trading” (according to IAS/IFRS) in the disposing investor’s financial statements;
- the participation is in a company that is not resident in a tax haven;

CORPORATE INCOME TAX

IRES: 27.5% (down to 24% from 2017)

PEX

Capital gain and dividend exemption (95%)

INTEREST EXPENSES

deduction up to 30% of GOI

NID

for 2016, 4.75% of national deduction on equity increased

- the participation is in a company that carries on an actual trade. As a general rule, disposal of stakes in passive income companies or in real estate may not qualify for the exemption.

Interest expenses: restrictions (“Gross Operating Income” rules)

Interest expenses are generally deductible from taxable income, up to the amount of (I) taxable interest revenues and (II) 30% of so-called “Gross Operating Income”, *i.e.* the difference between total revenues and operating costs (e.g., cost of goods sold, general expenses, etc.), disregarding depreciation, amortisation and rental payments for financial leases.

The amount of interest expenses exceeding the threshold is non-deductible in the fiscal year, but still may be carried forward to future fiscal years (so-called “interest carryforwards”). In case of a loan granted by a related party, especially when such party is non-resident, transfer-pricing rules shall also be accounted for.

Notional Interest Deduction

The so-called “Notional Interest Deduction” (“NID”) is an incentive to reduce the disadvantages of funding using equity (which results in non-deductible dividend payments) instead of debt (which generally results in deductible interest payments – within the above-mentioned restrictions). NID consists in a notional deduction to be calculated on equity increases arising from (I) cash contributions and (II) retained earnings. On the other hand, any equity decrease (e.g., dividend distribution or capital repayment) shall reduce the applicable NID base. The applicable deduction from taxable income is calculated by multiplying the NID base by the NID rate, *i.e.* (I) 4.75% for FY 2016, and (II) yet to be determined for future fiscal years.

Whenever taxable profits are lower than the applicable deduction, any exceeding NID shall be either carried forward for future fi-

scal years (so-called “NID carryforwards”) or converted into a tax credit for IRAP purposes. Specific anti-avoidance rules apply in some cases (mostly, with reference to intra-group transactions such as “waterfall cash contributions”) in order to counter the risk of multiple deductions.

Foreign tax credit

Domestic provisions and Double Taxation Agreements with other countries mitigate the risk of double taxation potentially arising on income already taxed in other jurisdictions, by means of specific foreign tax credit (“FTC”) provisions.

CFC rules

Rules on controlled foreign companies apply to subsidiaries located in tax havens – *i.e.* non-EU countries with (ordinary or special) tax regimes, where nominal corporate tax rates are at least 50% lower than the Italian one – providing for taxation of subsidiary income in the hands of the Italian parent company. These rules also apply to foreign companies located in countries other than a tax haven (including EU countries), which, in general, have the following features: (I) they are mere passive income companies and (II) they are subject to low levels of taxation, *i.e.*, their effective tax rate is at least 50% lower than the Italian one.

Transfer Pricing rules

Profits and losses arising from transactions with a foreign parent/subsidiary/sister company must occur at arm’s length. Italy generally complies with OECD principles on the matter (OECD Transfer Pricing Guidelines). Particularly, companies preparing a certain set of documents (generally, a Masterfile, a Country File and, recently, a Country by Country Report), detailing their own transfer pricing policies, are generally non-liable to penalties for failure to accurately comply with the arm’s length principle.

Tax consolidation

Italy has two different tax unit regimes in force, allowing groups of companies to file consolidated tax returns:

■ National Tax unit regime

Any Italian resident company can enter the national tax unit regime by making an election together with its (direct or indirect) subsidiaries. The election allows the parent company to assess and pay taxes on a consolidated taxable base, filing consolidated tax returns, and taking advantage of certain tax benefits, *i.e.*, mainly:

- **Tax losses:** the right to immediately offset a company's tax losses against another company's taxable profits within the tax unit;
- **Interest expenses:** any interest expenses that are non-deductible on a single entity level, may become deductible at a group level, by considering exceeding Gross Operating Income capacities by other group members in the tax unit;
- **NID:** any NID exceeding taxable income of a single company may be used to offset consolidated taxable income at a group level.

Following recent amendments in legislation, access to the tax unit regime has been extended to (I) Italian sister companies controlled by the same EU/EEA parent and to Italian permanent establishments of different EU/EEA companies under common control.

■ Worldwide Tax unit regime

A few Italian resident persons (e.g., resident listed companies) may also enter the worldwide tax unit regime: for the regime to be effective, all non-resident subsidiaries must opt into it together with their Italian (direct or indirect) parent company. When the regime is

in force, the parent company shall assess and pay taxes on a consolidated taxable base and file consolidated tax returns (also taking into account any applicable FTCs on taxes paid by foreign subsidiaries).

Transaction costs

The tax treatment of the transaction costs ("TC") depends on the type of costs. Generally, TC are deductible if related to services performed on behalf of the company performing the acquisition.

TC related to the participation acquisition have to be capitalized on the purchase price, and consequently they will not be deductible from a tax perspective.

TC related to bank financing, and capitalized as intangible assets (that should include also the 0.25% substitute tax), will be deductible, within the limits of the annual amortization cost recorded in the profit and loss account.

Other residual TC, recorded directly in the profit and loss account, could generally be considered as deductible costs.

With reference to VAT connected to such TC, TA may argue that VAT related to those TC is not deductible. However, VAT supported on the TC related to services concluded and billed after the merger may be deducted.

Non-deducted VAT could be added to the gross amount of TC supported and recorded in the financial statement.

3.1.2 REGIONAL BUSINESS TAX ("IRAP")

As a general rule, corporate taxpayers are also subject to IRAP on the so-called "net value of production", determined as the difference between total revenues and costs of production, without taking into account: (I) employee costs and similar costs (where they regard

TAX CONSOLIDATION REGIME

IRAP

3.9% on "net value of production"

VAT

standard rate 22%

**SUBSTITUTE TAX
ON BANK LOAN**

0.25% instead of indirect taxation on
security package

employment under a fixed-term contract), (II) interest expenses accrued, (III) bad debt expenses and (IV) extraordinary items.

The standard rate for IRAP purposes is 3.9%, but Italian Regions may generally choose to increase or decrease the rate by 0.92%. Furthermore, there are several provisions introducing cases of tax base reduction.

3.1.3 PROVISIONS ON NON-OPERATING COMPANIES

A company is considered “non-operating” (so called “dummy companies”) where it is deemed to be set up for the mere exploitation of goods, *i.e.* not for a genuine business/economic reason. Where specific conditions are verified, a deemed taxable income should be considered from IRES and IRAP purposes and use of VAT tax credit is restricted.

Provisions on non-operating companies also apply to companies that, during the past five fiscal years, either (I) attained tax losses for each subsequent year, or (II) attained tax losses for four years and taxable income for one year, which was lower than estimated taxable income calculated according to the above dummy company rules (“Systematic Loss Test”).

Regarding the abovementioned rules, specific provisions apply to holding companies.

3.2 INDIRECT TAXATION**3.2.1 VALUE ADDED TAX (“VAT”)**

Italian companies are generally taxable persons for VAT purposes. In general, VAT is due on any supply of goods and/or services on Italian territory. In addition, any importation of goods from non-EU countries is subject to VAT.

Italian VAT rates include a standard rate (22%) and two reduced rates (10% and 4%), for certain transactions (e.g. food and drink purchases, books, energy, *etc.*). In line with provisions of the VAT Directive, there is also a list of transactions that are exempted from VAT (e.g., financial transactions, medical care, *etc.*).

3.2.2 REGISTRY TAX AND OTHER REGISTRATION TAXES

Registry tax is an indirect tax on wealth transfers due upon registration of public or private deeds. Registration is sometimes mandatory (e.g., deeds certified by a notary, leases, *etc.*) and sometimes when a so-called “case of use” of the act or deed occurs, *i.e.* when the parties involved want to give certainty to the provisions therein contained. Registry tax may be levied, depending on the type of deed, in fixed amount (generally, 200 Euro) or at a proportional rate to be calculated on the value of the goods/rights object of the deed. Whenever a transaction is subject to both VAT and registry tax, the latter generally applies in fixed amount (200 Euro). The main exceptions to this rule generally regard particular VAT exempt real estate transactions, with reference to which additional registration taxes may also be charged (“imposta ipotecaria” and “imposta catastale”).

3.2.3 SUBSTITUTE TAX ON BANK LOANS

In case of transactions involving long-term bank loans, *i.e.* loans lasting longer than 18 months, contracted under an agreement negotiated and stipulated in Italy, taxpayers may elect to pay substitute tax at a 0.25% rate. The payment of this tax is only elective and alternative to payment of ordinary registry tax, additional registration taxes (on the loan security package) and other minor taxes (e.g., stamp duty). Taxpayers generally consider payment of substitute tax in lieu of other ordinary applicable (present and/or future) indirect taxes, in light of the tax burden arising from transactions, formalities and securities that are ancillary to or that may arise in the future because of the loan agreement.

3.2.4 FINANCIAL TRANSACTIONS TAX (OR “TOBIN TAX”)

Italy levies financial transaction tax on qualified equity transactions of up to 0.2% of the value of the trade. As a general rule, equity transactions involving shares in Italian joint-stock companies (“S.p.A.”) are subject to FTT, whereas those involving an interest in a limited liability companies (“S.r.l.”) are not.

3.3 WITHHOLDING TAXES ON OUTBOUND DIVIDEND PAYMENTS

As general rule, outbound dividend payments are subject to 26% withholding tax.

As pointed out in the following table, where specific conditions are met, more favourable WHT rates can be applied.

WHT ON OUTBOUND DIVIDEND PAYMENTS	WHT RATE	REQUIREMENTS (WHERE ANY)
Ordinary WHT	26%	N/A
Reduced DTT	DTT rate	Subject to the provisions of DTT
Reduced EU	1.375%	Resident in another EU Member State, and ordinarily subject to corporate income tax. Not applicable for conduit companies.
Parent-Subsidiary Directive (PSD)	Zero-rate	<ul style="list-style-type: none"> ■ forms listed in Annex I, Part. A of the PSD; ■ both companies are subject to one of the taxes listed in the Directive; ■ minimum holding of 10% in the capital of the subsidiary, for least 12 months; ■ proof of non conduit company.

TOBIN TAX

0.2% of the value of the trade (not applicable for S.r.l.)

3.4 WITHHOLDING TAXES ON OUTBOUND INTEREST PAYMENTS

As general rule, outbound interest payments are subject to 26% withholding tax.

As pointed out in the following table, where specific conditions are met, more favourable WHT rates can be applied.

Summary table

WHT ON OUTBOUND DIVIDEND PAYMENTS	WHT RATE	REQUIREMENTS (WHERE ANY)
Ordinary WHT	26%	Full exemption for interest paid, among others, by banks, and listed companies, if the investor is resident in a whitelisted country.
Reduced DTT	DTT rate	Subject to the provisions of applicable DTT.
Interest and Royalties Directive	Zero- rate	<ul style="list-style-type: none"> ■ the forms listed in the Annex of the Directive; ■ both companies are subject to corporate taxes (as listed in the Directive); ■ a minimum holding of 25% for least 12 months; ■ proof of non conduit company.

3.5 TAX RULINGS

3.5.1 INTERNATIONAL RULING

On March 21st, 2016, the Italian TA issued its administrative provisions for implementation of new rules on advance tax agreements for enterprises with international activities. According to these provisions, all enterprises with international activities may enter an advanced tax agreement with the TA on specific subject matters, regarding, among others, transfer pricing and permanent establishment issues, application of company migration rules, taxation of inbound and outbound dividends, interest, royalties, *etc.*, according to domestic legislation and/or Double Tax Treaty provisions.

After reaching an agreement with the taxpayer, the TA issue a tax ruling, which is binding and remains in place for five fiscal years (potentially renewable) on condition that (I) the juridical and/or factual circumstances of the agreement do not change and (II) the taxpayer fully abides by its provisions.

The chances to apply the provisions in hand are, at this stage, limited for foreign investors with no subsidiary or permanent establishment in Italy.

3.5.2 TAX RULING FOR MAJOR INVESTMENTS

Private equity investors interested in carrying out an investment in Italy for an amount exceeding 30 Euro Mln having a significant and lasting impact on employment may now benefit from the provisions on the so-called advance tax ruling for major investments.

According to the provisions in hand, the investor may file a request to the Italian TA in order to determine the tax treatment of an investment plan and of any potential extraordinary transactions in-

involved in it. It is important to highlight that, while applying the advance tax ruling, the investor may formally ask the TA's opinion on any other tax issue related to the investment, such as potential violations of law or whether the mandatory conditions for establishing a favourable tax regime are met.

The Italian TA must provide a written and reasonable reply to the investor within 120 days from the filing of the request. Should the TA need further information, this term may be extended by additional 90 days, starting from the day the TA receives such information. In order to retrieve all the information needed, it is also possible for the TA to carry out an assessment on business premises, where the activity is conducted.

If the Italian TA issue no reply within the above said terms, it is implied that the TA agrees with the interpretation the taxpayer has offered in its request.

In all the cases described above, the TA reply (or non-reply) shall be binding as long as the legal and/or factual conditions remain unchanged and the taxpayer keeps abiding by its provisions.

DEAL STRUCTURING

This chapter contains a brief overview of common investment schemes used by private equity investors when structuring their acquisition.

The investment is usually structured as follows:

- **Step 1:** incorporation (or purchase) of an Italian intermediate company (“BidCo”);
- **Step 2:** funding of BidCo;
- **Step 3:** acquisition of target;
- **Step 4:** post-closing phase;
- **Step 5:** exit phase.

4.1 INCORPORATION (OR PURCHASE) OF BIDCO

The first step generally involves the creation of an intermediate Italian company (“BidCo”), which shall directly carry out the acquisition; SPV may set up BidCo as a new company or purchase full stakes in an already existing one.

As a general rule, from a tax perspective:

- **Incorporation of BidCo** by payment of the initial cash contributions to set up the company entails (I) no VAT liability since, according to Italian legislation, this is not a

taxable transaction for VAT purposes, and (II) payment of registry tax in the amount of 200 Euro upon registration.

- **Purchase of BidCo** by payment of a consideration in exchange for the interests or shares in BidCo entails (I) no VAT liability, since the transaction is VAT exempt and (II) payment of registry tax in fixed amount (200 Euro) upon registration of the deed or purchase agreement. Moreover, should the purchase entail a transfer of share certificates (*i.e.*, only for joint-stock companies), it will also be subject to Financial Transactions Tax (0.2% of the purchase price).

After the purchase, BidCo may be converted into a S.p.A. in order to allow for more flexibility from a corporate perspective (e.g., creation of different share classes, possibility to issue notes and other financial instruments, etc.). From a tax perspective, conversion of an S.r.l. into a S.p.A. is not a taxable transaction for VAT purposes; registration of the deed, however, will trigger registry tax for 200 Euro.

4.2 FUNDING PHASE

As a general rule, in a pre-closing phase, appropriate resolutions may need to be taken in order to increase BidCo’s share capital. These

capital increases will allow BidCo, among others, to (I) have the necessary resources in order to carry out the investment, (II) offer to other (potential) investors, generally the former top management/entrepreneur (“Co-Investors”) the opportunity to co-invest and (III) cover any of BidCo’s other funding needs (mainly, the payments of transaction costs). As stated in the above paragraph, cash contributions in a company are non-taxable transactions for VAT purposes and are subject to registry tax in fixed amount (200 Euro). From a direct tax perspective, the aforementioned capital injection may benefit from NID: specific anti-avoidance rules should be also considered.

Additional resources may also be provided (I) by other Co-Investors, in the form of a shareholder loan (as is the case, for example, for vendor loans), and, (II) in case of leveraged buyouts (“LBOs”), via bank loans.

With reference to LBOs, banks may grant different kind of facilities (or “lines”) such as term facilities, revolving credit facilities and bridge-to-cash facilities. From a tax perspective, whereas shorter-term facilities (e.g., bridge-to-cash) may not qualify for substitute tax on financial loans, said tax may usually apply to the term facilities and to the revolving credit facility (both lasting longer than 18 months).

Opting for substitute tax may be convenient where the loan’s security package includes (I) securities provided by third parties and not directly by the borrower (pledge over quotas of target company’s subsidiaries) or (II) mortgage on real estate properties or (III) future extension or modification of the security package.

Recent case-law by the Italian Supreme Court has established that:

- **refinancing transactions** may not benefit from the regime in hand, setting a new requirement to enter the substitute tax regime, *i.e.*, the new resources are used in order to finance a “productive investment”;

- provisions included in facility agreements, granting banks the **right to withdraw loans previously granted** are not compatible with the substitute tax regime.

On March 30th, 2016, the TA released relevant guidelines on (merger) leveraged buyout transactions via Circular letter n. 6/2016 (the “Circular Letter”).

The Circular Letter has finally established that LBO transactions may not be deemed abusive by the Italian TA, *i.e.* the TA may not challenge such transactions in light of alleged “anti-avoidance” concerns, also given that these investment structures (I) are generally ruled by specific provisions within the Italian Civil Code and (II) are often imposed by third party lenders.

4.3 ACQUISITION OF TARGET

Acquisition of target may occur via an “asset deal” or a “share deal”. Asset deals are relatively rare because they are less efficient both for buyer and for seller.

Share deal

A share deal entails the acquisition of shares by BidCo in the target company/companies from another party (*i.e.* the “Seller”) in exchange for cash.

From a direct tax perspective:

On the side of the **Seller**, if it is an Italian resident company, it may trigger limited taxation on any capital gains for IRES purposes, thanks to participation exemption rules. IRAP may also apply if the sale was made by a holding company.

On the side of **BidCo**, this transaction usually does not allow the

SHARE DEAL

Limited taxation on capital gains (95% exemption)

buyer to step up the tax basis of the assets of the acquired company. BidCo will book the participation at cost, generally within the “fixed financial assets” category, in order to benefit from participation exemption rules upon disposal (exit phase).

From an indirect tax perspective, a share deal is:

- generally regarded as a taxable transaction for VAT purposes, even though it benefits from VAT exemption;
- subject to registry tax in fixed amount (200 Euro) upon registration of the deed (provided no other provisions be mentioned, that do not qualify as taxable transactions for VAT purposes);
- subject to Tobin Tax at a 0.2% rate, if it involves a transfer of share certificates.

Asset deal

An asset deal entails the acquisition of target by BidCo via purchase of the “going concern(s)” – *i.e.* of the total amount of its assets (and liabilities) or part(s) thereof – from another party (the “Seller”) – *i.e.*, the legal entity/entities that used to carry out the business pertaining to that (those) going concern(s).

From a direct tax perspective:

- on the side of the **Seller**, sale of the assets triggers taxation of any capital gain realised in the hands of the selling entity for IRES purposes.
- **BidCo**, on the other hand, books the purchased assets in its financial statements, together with any previously unrecognised intangibles (e.g., trademarks, goodwill, etc.).

From an indirect tax perspective, since the transfer of the assets in hand shapes a going concern, the transaction is not VAT relevant: therefore, registry tax generally applies at a tax rate of 3% (or higher at tax rate if specific assets are involved).

4.4 POST-CLOSING PHASE

After closing, with reference to share deals, BidCo may (in some circumstances) evaluate the following alternatives:

- **Remaining as holding company:** under this alternative, the main tax issues follow:
 - BidCo may be subject to “Non-operating company” rules and, therefore, it will need adequate revenues to pass both the Revenue Test and the Systematic Loss Test.
 - BidCo and the acquired company/companies **may enter domestic tax consolidation**, thus enjoying the benefits of the regime.
 - BidCo may need to be **actively involved in the management of its subsidiary/subsidiaries**, e.g., by providing services that may benefit the group as a whole, in order to be allowed to **deduct input VAT**.
- **Merge with the acquired company/companies:** the merger should be carried out in accordance with a procedure providing specific fulfilments/documents and information, stated by the Italian civil code where an LBO transaction occurs (art. 2501-bis ICC). From an accounting standpoint, a merging difference will arise, *i.e.* the difference between the participation cost and the book value of the assets and liabilities of the acquired company/companies. This difference will need to be allocated to existing assets and/or to previously unrecognised intangibles, according to their real value. From a tax perspective:
 - the merger is a tax neutral transaction; thus, it would be impossible to step-up the tax values of the newly-acquired assets, unless a specific substitute tax is paid (ranging from 12% to 16%);
 - the merger will result in a company (“MergeCo”), which will inherit the NID deduction accrued by

ASSET DEAL

- Taxation of capital gain without deduction
- For BidCo, tax relevance of any goodwill arising from the deal

the merged companies (within the limits of its equity capital book value);

- tax losses and interest carryforwards of the merging companies may be deductible for MergeCo within quantitative limitations (based on the equity book value of the original company) and on condition that the merging company originating said carryforwards was able to pass a specific vitality test (based on past revenues and employee numbers). A specific ruling should be submitted to the TA in order to ask for the complete deduction of said tax losses and interest expenses.

4.5 EXIT PHASE

The exit phase generally occurs with a disposal of interest/shares in the target company (share deal). The specific tax effects depend on the structure chosen.

In any case, the following general rules should apply:

- any outbound dividend or interest payment is subject to withholding taxes under the rules pointed out within Chapter 3, par. 3.3 and 3.4;
- any gain from disposal of shares in Target may be taxable in Italy, **if they regard a sale of a so-called “qualifying participation”**, *i.e.* of shares granting:
 - more than 25% of capital ownership (5% for listed stock); and/or
 - more than 20% of the voting rights (2% for listed stock).

Foreign shareholders, however, may benefit from a more favourable tax treatment according to the existing double-taxation treaty between Italy and its country of residence: as a general rule, tax treaties (in

line with the provisions of article 13, par. 5, OECD Model) grant exclusive taxing powers to the country of residence, assuming that at the exit date foreign shareholders will have adequate resources in the country of residence and qualifies as the “beneficial owner” of the proceeds. That means, *inter alia*, that foreign shareholders should have the power and rights to freely use the proceeds gained, without making automatic payments to its stakeholders.

MANAGEMENT INCENTIVE SCHEMES

This chapter takes into account management incentive schemes with reference to Italian residents. Italian residents are generally subject to individual income tax (“IRPEF”) at progressive rates.

According to Italian tax provisions, whatever is earned by an employee (manager) in connection with (as a result of) the employment relationship, even if independent from the work (activity) actually performed, i.e. independently from the synallagmatic link between (I) effectiveness of work performed and (II) the sums and values received, should be included within the employment income category and regarded as employment income. Such principle applies even if the attribution is made by a third party (not directly by the employer). Within the evaluation of the attribution made to the employee, the “fair market value principle” should be followed.

The most common incentive schemes are:

Cash bonus

It is a form of variable wage, which is generally related to the achievement of certain business performance objectives.

Tax aspects for the employer: the bonus payment is taxable as employment income upon receipt and social security contributions are due on the bonus amount.

Tax aspects for the company: in general, the consideration paid to the employer is deductible from taxable income, including the stake of social security contributions. In some cases, tax authorities might challenge the amount of the bonus, should they deem it “unreasonable” in the amount.

Stock Option Plans and stock grants

A stock option plan may be defined as the attribution to an employer of non-transferable call options on stock, i.e. the right to buy shares of their company (or of another group company), after a certain period of time (vesting period) at a certain price (strike price). The plan may also entail subsequent obligations for the employer (i.e. a minimum holding period for the shares).

Tax aspects for the employer: any difference between the market value of the shares and the consideration payable to exercise the option (equal to zero, in case of a stock grant) is taxable as employment income and subject to IRPEF upon exercise. After that, as general rule, any other income derived by the employer **in his capacity of investor/shareholder** should not be regarded as employment income, but as **financial income** (e.g. income from dividends) and/or **capital gains** (e.g., upon disposal of the shares), and shall be taxable according to the specific rules applying to said income categories.

No social security contributions are due on stock option plans (both from employer and company side).

Tax aspects for the company: Italian GAAP companies may not book any costs in their income statement. As a consequence, no deductible costs are recognised for IRES purposes. IAS companies may book a portion of the stock option cost as employees cost and deduct it under IRES perspective.

Attribution of special class shares

Special class shares generally have limited voting powers and may be privileged in terms of dividend rights (conditional on achievement by the company of certain business performance objectives).

Tax aspects for the employer: assuming that the employer paid a “fair” consideration for the shares in hand, i.e. in line with their market value (as documented by an *ad hoc* business appraisal) no taxable income should arise from the purchase of the shares. Future income pertaining the shares should be qualified as (I) financial income (e.g., income from dividends) and/or (II) capital gains on disposal, and be taxed according to their particular income category. On the contrary, should the market value of the shares at the moment of the purchase be higher than the consideration paid by the employer, the difference shall be taxed as employment income.

Tax aspects for the company: no deductible costs are recognised for IRES purposes.

Attribution of warrants

A warrant is a transferable call option, granting its owner (under certain conditions, i.e., generally, if the company achieves its business performance objectives) the right to subscribe an underlying instrument (e.g., shares) at a strike price on or by a certain date (“vesting date” or “vesting period”).

Tax aspects for the employer: assuming that the employer paid a “fair” consideration for the warrants, i.e. in line with their market value (as documented by an *ad hoc* business appraisal), no taxable income should arise upon purchase or upon exercise of the warrants (this principle is yet to be confirmed by the Italian tax authority). Future income deriving from the underlying shares after exercise of the warrant generally qualifies as (I) financial income (e.g., income from dividends) and/or (II) capital gains on disposal, and be taxed according to their particular income category. On the contrary, should consideration paid for the warrant be lower than their market price, the difference shall be taxed as employment income and social security contributions should be due as well.

Tax aspects for the company: no deductible costs are recognised for IRES purposes.

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