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Authorities clarify tax treatment of LBO transactions

Contacts

Francesco Saltarelli
fsaltarelli@sts.deloitte.it

Luca Bosco
lubosco@sts.deloitte.it

Stefano Schiavello
stschiavello@deloitte.com

Italy's tax authorities issued guidance on 30 March 2016 (Circular 6/E) that clarifies the tax treatment applicable to the acquisition of Italian targets by private equity funds through leveraged buyout (LBO) and merger leveraged buyout (MLBO) transactions. In a welcome move, the authorities confirmed that interest expense related to loans granted to an Italian special purpose vehicle (SPV) incorporated for the purpose of acquiring the target is deductible under the ordinary rules. This has been an area fraught with controversy and challenges by the tax authorities on the grounds that the transactions were abusive and lacked a business purpose. The clarification likely should end most of the current tax litigation and prevent further challenges to LBOs.

Although the guidance is specifically aimed at private equity acquisitions, the principles it provides on several other topics, including the withholding tax applicable to dividends and interest paid to nonresidents and the treatment of capital gains on the subsequent sale of the Italian target (i.e. "exit taxation"), should be applicable to corporate acquisitions as well.

Deductibility of interest expense on loans granted to Italian SPV

The circular clarifies that, in principle, interest expense incurred on financing obtained by an Italian SPV to acquire an Italian target should be considered a "business expense" and, therefore, should be deductible for corporate income tax purposes, subject to the 30% EBITDA limitation (under which net interest expense is deductible up to an amount equal to 30% of earnings before interest, taxes, depreciation and amortization, as shown in the profit and loss statement) and, in the case of a related foreign lender, to the extent the loan is on arm's length terms. (See below for special considerations relating to shareholder loans.)

The business expense principle is applicable regardless of whether the SPV and the target intend to merge after the acquisition or remain separate entities and opt for tax consolidation. A merger is the natural final step of an MLBO transaction, and the authorities recognized that this acquisition technique, which often is required by third-party lenders, generally is supported by an actual business purpose, and thus is not carried out merely to obtain a tax benefit.

In addition to confirming the tax deductibility of interest expense, the circular states that the purchase of the Italian target by an Italian SPV cannot be considered a service provided to a foreign parent company and, therefore, the SPV is not entitled to an arm's length (taxable) remuneration (which often was the position taken by Italian tax inspectors seeking to challenge a transaction). On the contrary, where the private equity fund arranges for the financing for the acquisition, the SPV should have to pay an arm's length consideration for the services provided by the fund.

Through the above clarifications, which are substantially in line with the principles of Italy's recently implemented general anti-abuse rule (GAAR) (for prior coverage, see the *World Tax Advisor* "in brief" item dated 23 October 2015) the tax authorities have acknowledged that LBOs/MLBOs are not schemes designed to avoid taxes (although exceptions are made for specific situations, e.g. where the acquisition is carried out by shareholders of the target), and the tax deductibility of the related interest expense generally is legitimate.

Treatment of shareholder loans

In certain cases, a deduction for interest expense on shareholders' loans granted by foreign investors to an Italian SPV may be disallowed and the interest may be recharacterized as equity. The circular provides that such interest expense may be deductible to the extent the relevant financing effectively qualifies as a loan and the loan is on arm's length terms. The tax authorities will examine the provisions of the agreements (including the agreements signed with third-party lenders) to determine whether the intercompany financing should be treated as genuine financing and not recharacterized as a capital injection made by the shareholder. A recharacterization of interest expense would have the following consequences:

- Interest expense would not be deductible for corporate income tax purposes;
- The (deemed) capital injection would, in principle, qualify for the notional interest deduction (the current rate is 4.75%); and
- Dividend withholding tax (1.375% on payments to EU and European Economic Area (EEA) residents, and 26% on payments to other nonresidents under domestic rules) would apply instead of interest withholding tax (26% on payments to nonresidents under domestic rules).

Net operating losses (NOLs) and excess interest carryforwards

The circular acknowledges that the limitations on the carryforward of NOLs and excess interest expense in the case of a merger (which is normally subject to the "vitality test," an anti-abuse rule based on the revenue and labor costs shown in the past three financial statements) should not be applicable in a MLBO context where the SPV is incorporated for the purpose of being merged shortly after the acquisition of the target. As long as the taxpayer can prove that the excess nondeductible interest expense and NOLs it seeks to carry forward were exclusively originated by loans obtained in the MLBO, it may obtain a ruling from the tax authorities that the vitality test does not apply to limit the carryforwards.

Interest withholding tax

The circular confirms that, to determine whether the domestic withholding tax on interest paid to foreign lenders (26%) may be reduced or eliminated by a tax treaty or the EU interest and royalties directive, an analysis of the facts and circumstances must be made to ascertain whether the recipient is the beneficial owner of the interest income, taking into account the extent of the back-to-back nature of the financing in terms of amounts, conditions, interest rates, payment terms and “nonrecourse” clauses.

The circular identifies two cases where the interest recipient will not qualify as the beneficial owner and the domestic withholding tax potentially is applicable:

- Where the SPV is financed by an Italian bank acting as a front structure in a “IBLOR agreement,” where the loan is syndicated among nonresident lenders; or
- Where the loan is made to the SPV by a nonresident group company in a back-to-back arrangement.

However, the circular confirms that, in any case, no withholding tax is applicable if the SPV received a medium/long-term loan (i.e. a loan with a term of more than 18 months) from one of the following lenders (directly or indirectly, even through one of the structures mentioned above):

- Banks and insurance companies established and authorized under the legislation of an EU member state; or
- Foreign institutional investors subject to regulatory supervision in their country of establishment, even if the investor is transparent for tax purposes.

Taxation on exit from the investment

The *“exit”* from the investment in a target generally is made in one of two ways, depending on the specific structure:

1) A foreign (usually EU) holding company sells the Italian shares (i.e. the shares of the SPV or the company resulting from the merger); or
2) An Italian holding company (or SPV, if not merged with the target) sells the Italian shares (i.e. the shares of the company resulting from the merger or the target) and makes a dividend distribution to a foreign (usually EU) holding company.

In both cases, the investment structure allows the transaction to benefit from the EU parent-subsidiary directive or an applicable tax treaty to eliminate any (substantial) Italian taxation on the exit from the investment. In particular:

- In case 1) above, there would be no Italian taxation of the capital gains arising from the disposal of shares under the application of the capital gains article of a relevant tax treaty (since Italy’s treaties, in principle, allocate the right to tax the gain to the state of residence of the seller);
- In case 2) above, the gains generally would be 95% exempt under the Italian participation exemption, and the subsequent dividend distribution either would be exempt from withholding tax under the EU parent-subsidiary directive or subject to the reduced 1.375% rate for dividends paid to EU/EEA resident companies; and
- In both cases, no significant taxation generally would apply in the EU holding jurisdiction.

The authorities acknowledge in the circular that the achievement of the results above is in accordance with the EU principle of freedom of establishment, as long as the legal entities involved have genuine “economic substance.” To demonstrate economic substance, the intermediary entities involved in the transaction must have an actual connection with the economic system of their country of establishment and cannot be mere "conduit," i.e. an entity that does not carry out any real business activity with reference to the specific transaction.

The circular confirms that the economic substance requirement will not be met if an intermediary entity:

- Has a "light structure" (e.g. when the employees, office space and equipment are provided by a "domiciliary company" through a management service agreement), lacking real business activities and actual (i.e. not only formal) decision-making power (e.g. on the management of the investment); or
- Is a mere conduit structure with reference to the specific transaction, in a substantial back-to-back position.

In these cases, unless the taxpayer can prove the existence of a business purpose other than optimizing the tax results, the ITA, following the procedure provided by the recently amended GAAR, will disregard the existence of the intermediary entities and apply the tax treatment provided for an investment made directly by the private equity fund.

Finally, considering that funds generally are fiscally-transparent entities, the circular confirms that, if all the relevant requirements are met, the investors may directly invoke the application of a relevant tax treaty between Italy and their country of residence.

Comments

Circular 6/E provides important clarifications on the tax treatment applicable to the acquisition of Italian targets by private equity investors through LBO and MLBO transactions. The relevant principles in the circular also should be applicable to corporate acquisitions. These principles should be considered, not only for structuring new acquisitions, but also to identify any possible impacts of the circular (e.g. recharacterization of shareholder debt into equity) on acquisition structures currently in place.
