Tax guidance on leveraged buy-out transactions

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On March 30 2016 the Tax Authority issued Circular 6/E, providing general guidelines regarding leveraged buy-out transactions and similar acquisition structures, with particular reference to investments made by private equity funds. In recent years, the Tax Authority has issued material tax assessments relating to leveraged buy-out transactions, challenging the deduction of related costs (eg, interest payments and management costs) and input value added tax (VAT).

Tax deduction of interest expenses

The Tax Authority has acknowledged that interest expenses incurred by an Italian special purpose vehicle (SPV) regarding the debt undertaken to acquire an Italian target company should be considered a business expense.

As a result, interest expenses are considered inherent to business activity and are deductible for corporate income tax purposes in the case of:

- a merger between an SPV and a target company; or
- the election of tax consolidation between the SPV and the target company.

The rules governing the deduction of interest (eg, 30% of adjusted earnings before interest, taxes, depreciation and amortisation limitation) and general transfer pricing (in the case of cross-border intragroup flows) apply. This marks a new approach by the Tax Authority, which indicated in the circular that pending litigation with taxpayers in this regard could be waived, but on a case-by-case basis.

Under the previous and existing Consolidated Tax Act, interest expenses could not be challenged using the inherent cost test. The Tax Authority's argument in this regard (ie, that interest expenses were an SPV shareholder cost rather than a target company cost and SPV business activity) was unreasonable and questionable.

Interest expenses remain deductible, but are limited to 30% of the earnings before interest, taxes, depreciation and amortisation ratio.

Fees charged by private equity firms

Circular 6/E focuses on fees that private equity firms charge the acquisition vehicle or target company, recognising that – in principle – such fees (generally for support, monitoring and management activities) are deductible if, after a careful examination, the inherent cost test is fully met.

For example, such fees are not deductible if they reflect activities conducted in the interest of SPV shareholders. In this regard, the circular establishes a non-exhaustive list of criteria to test whether these fees reflect activities that are beneficial to the fund's investors (eg, the reduction of management fees charged to the fund's investors or the payment of fees which are proportionate to the investor's share in the SPV-target company structure – which is more likely to be treated as a dividend, with withholding issues arising in addition to the deduction).

Further, management fees must be considered from a VAT perspective. In particular, if fees reflect activities conducted in a fund investor's interest, the VAT charged on such fees (if any) will not be deductible, as it relates to non-inherent cost. Moreover, VAT on fees is not recoverable if the SPV's only activity is to hold shares, regardless of whether the acquisition vehicle is then merged with the target company.

Withholding tax on interest

Circular 6/E addresses the tax treatment applicable to interest paid in connection with Italian Bank of Lender of Record (IBLOR) loans and structures for the syndication of debt via an EU vehicle.

In the case of IBLOR loans, where the loan is considered to be transparent, the borrower directly applies a withholding tax on the share of interest owed to the non-resident creditor.**(1)** Conversely, where the IBLOR loan is considered to be opaque, the borrower applies no withholding tax on the interest paid to the Italian bank, which applies no withholding tax on non-resident creditors should specific exemptions apply. According to the Tax Authority, credit support providers are the real recipients of the Italian-source interest and, therefore, withholding tax must be applied.

With reference to structures for the syndication of debt via an EU SPV, the circular specifies that withholding tax does not apply on interest paid by an SPV on a loan granted by an EU parent company, in accordance with the EU Interest and Royalties Directive (2003/49/EC), as modified under Italian tax law. However, in the case of no beneficial owner, the lending is viewed as a back-to-back loan. As a result, withholding tax must be applied rather than the interest royalties exemption.

Shareholder loans

Circular 6/E also outlines the possibility of re-characterising – in accordance with Organisation for Economic Cooperation and Development transfer pricing guidelines – shareholder loans as injections of equity, with the consequent rejection of the deduction of interest expenses.

In particular, the Tax Authority has clarified that re-characterisation can take place, on a case-by-case basis, if, for instance, the following conditions are met:

- the repayment of the capital and interests conditional on the full reimbursement of third-party loans;
- the exclusion of shareholder loans from the financial ratios defined in the financial covenants of third-party loans; and
- the repayment of capital and interests under shareholder loans subject to contractual restrictions similar to the distribution of dividends and equity reserves.

If a shareholder loan matches the above conditions and can be considered an equity injection, the circular clarifies that the equity increase must be considered for the purposes of a notional interest deduction (ie, the allowance for corporate equity) and interest expenses as dividends for withholding tax purposes.

Taxation on exit disposal

Circular 6/E addresses the issue of the structures that foreign investment funds use, such as EU holding companies, in order to avoid the ordinary tax regime applicable to foreign undertakings for collective investment in transferable securities. More specifically, it clarifies that where the holding company is proven to be a purely artificial creation, tax benefits may be disallowed. The circular confirms that the economic substance requirement will not be met if an intermediary entity:

- has a structure which lacks real business activity and decision-making power; or
- is a mere conduit structure.

In the absence of material non-tax reasons, tax benefits should be disallowed and the taxation applicable to an investment made directly by the fund should apply.

In this respect, the participation exemption applicable in Italy (which requires a one-year holding period, but not a minimum threshold participation) could in principle lead to the same result as an exit realised by a foreign holding company – that is, if the selling vehicle was resident in Italy, rather than overseas:

- a participation exemption system on capital gains would apply; and
- capital gains would be taxed in Italy only at 1.375%.

However, if the foreign holding is re-characterised as being Italian resident, criminal penalties could be levied against the SPV directors for omitting tax returns in Italy. For that reason, the assumption of double residence (ie, in the foreign incorporation country and Italy) could be a clever solution once the exit from the investment is close to taking place.

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Endnotes

(1) In an IBLOR structure, an Italian-based bank operates as the fronting lender, but signs corresponding agreements with non-Italian credit support providers in order to share the lending risk.

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