

Tax developments and their impact on private equity investments in Italy

Italy has one of Europe's most active leveraged buyout markets, and local regulators have been eager to ensure such activity is sufficiently taxed. LED Taxand's **Guido Arie Petraroli** and **Patrizio Braccioni** explore recent legislative tax changes in Italy and Europe and how this will impact private equity activity.

The essential tax rules and patterns related to private equity transactions in Italy are described in Circular No. 6 of March 30 2016 (Circular) of the Italian Tax Agency (ITA).

Although not much time has passed since then, many things have happened in the domestic and international tax and financial system, so it is important to go through the Circular again and understand whether substantial developments have taken effect.

This article will illustrate the new points when materially setting up acquisition structures or schemes.

Private equity in Italy

Firstly, traditional structures have not changed.

It remains that a foreign holding company (Holdco) set up by a foreign private equity fund will make the acquisition of the Italian target either directly or indirectly, by setting up an Italian holding company (Itholdco), that makes the acquisition of the target.

After an acquisition, the Itholdco may merge with the target through either a direct merger, or a reverse merger, particularly in situations where the target owns administrative licenses (for example, in the energy sector, which is very lively in the Italian M&A market).

Financing schemes through third party debt or using genuine shareholder loans remain valid alternatives in order to fund such transactions.

International buyout regulations

The issues at stake are different and depend mostly on the fast development of EU and international tax rules, together with domestic financial market and legal changes.

In our view, the most important change since the Circular was issued at the beginning of 2016, is the effective entry into force of the US



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Guido has a degree in economics (*Università Cattolica del Sacro Cuore* in Milan) and a master's degree in corporate tax law. He began his career at Andersen Legal in 1990 and continued his practice in Ernst & Young's tax department from 1999. Later, he moved to the firm's New York office. From 2003 until 2017 he worked for Fantozzi & Associati in Milan, where he was a partner. He founded LED Taxand with Alfredo Fossati in 2018.

Guido has over 30 years' experience advising Italian and large multinationals and institutional investors on a wide range of tax matters. He focuses on private equity transactions, including acquisition finance and real estate finance. Guido also has extensive experience in international tax planning, mergers and acquisitions, real estate transactions and reorganisations. He has a strong competence in the area of tax disputes litigations and mutual agreement procedures.

Foreign Account Tax Compliance Act (FATCA) and the common reporting standard (CRS) rules, which are causing a substantial change in the approach of the ITA towards private equity transactions.

In 2016, the ITA was hardly able to obtain information about the financial flows (mainly dividend and interest) that characterised these transactions. The ITA was aware that their knowledge was substantially limited within Italian borders, and obtaining an exchange of information (EOI), even from cooperative jurisdictions, was sometimes a long and difficult process.

Finally, the ITA was also aware that in the end, the acquisition of tax information would have been scarcely useful since the transaction would lead to entities that were resident in some non-cooperative countries, from whom no information would be available at all.

Common reporting standard

Since 2017, and even more so since 2018 when the CRS was materially adopted by all the late adopters, what was considered an opaque environment all of a sudden has become more or less transparent. In most cases, the ITA is now able to monitor, step by step, all financial income flows, and is entitled to ask details about them.

No action is substantially required by the ITA considering most tax information now flows automatically in its advanced IT systems.

A further issue that is causing a new (and sometimes aggressive) approach is the concept of beneficial ownership (BO), which is connected with the concept of substance.

These concepts are not new to international tax practitioners because they have been used for decades and have been the object of many commentaries.

Updated positions by the OECD on these subject matters have not changed substantially.

Holding companies

The most prominent update is that according to the tax information exchange from foreign tax authorities, the ITA is now able to check all the features and patterns of holding companies and their effective "rooting" into the local economy. In no case should a Holdco be characterised as a sheer conduit.

The Circular mentions that in the ITA's experience, holding companies sometimes do not possess material spaces or employ people. Sometimes, the labour is provided by external consultants and they do not really take any material decision.

For this reason, holding companies are assessed to determine whether there is a fictitious business presence of the Holdco in the country of residence. If the Holdco has a fictitious business, it cannot access all of the EU Treaty's freedom of establishment guarantees and, normally, is not the BO of the proceeds it receives from Italy either.

Withholding taxes

This environment may normally entail that in Italy the withholding tax (WHT) is levied at the ordinary rate of 26%.

With regards to interest, the risk of applying a higher WHT is lower with dividends because the Circular states that what matters is that interest flows towards a BO that is entitled to an exemption or a reduced WHT, even if the BO is not the first holder of the interest.

It should be underlined that according to Italian domestic law no WHT towards non-resident bodies will apply in Italy if:

- Financing is provided by an EU bank or a fund (even if the fund is a transparent entity) that is a resident in a white-listed country (a country which has an EOI with Italy);
- The management company of the fund is regulated according to its local juridical system; and

- The financing has a duration greater than 18 months (which is common sense in this business).

Permanent establishments

A third issue is the new concept of permanent establishment (PE) set forth by the OECD, where domestic taxation applies if a taxpayer has an “economic presence” in a foreign country.

It is clear that aligning the concept of a PE, where traditionally there is the need of a material establishment on the soil of a state in a permanent way, with the concept of economic presence (where there is no need of any traditional PE), is a big change.

Italy has already introduced the OECD economic presence concept in its legislation (Article 162 of the Italian consolidated direct tax text).

Article 162 applies only in respect to non-treaty countries, since Italian tax treaties have not changed the traditional PE concept.

Article 162 seems to be mainly addressed to the so-called digital economy. However, the letter of the law seems very broad and may reach situations beyond the digital economy.

Financing the target or Italian holding company

In regards to financing the Italian target or Itholdco, if the latter has been chosen, the Circular makes reference to traditional financing or to shareholder loans. The caveat the Circular puts forward is that interest should be genuine interest and not disguising capital. Furthermore, usual transfer pricing (TP) and/or arm’s-length rules should be applied.

The Circular does not consider alternative ways of financing which have steadily developed in the past two/three years (the so-called ‘mini-bonds’).

Mini-bonds are bonds issued by companies that are not either banks or listed companies. Thus, the standard amount of such bonds is generally limited between €2-10 million (\$2.25-\$11.2 million).

However, it must be clarified that the amount of mini-bonds is not limited by law, and you can find mini-bond amounts higher than €30-50 million in the market.

There are also no limits of duration either, though market practise leads to standard 3-5 years duration.

Mini-bonds can be listed or not in Italy (or in another EU regulated market, where Vienna is one of the preferred), as well as rated or not rated.

There are also recent cases where Italian banks have preferred to invest in mini-bonds rather than providing traditional loan finance to their corporate clients.

In the Italian market, there are also financial platforms which promote investment and/or trading of mini-bonds.

Interest on mini-bonds in the hands of non-resident investors is not subject to WHT, provided that investors are institutional investors, according to Article 100 of the Italian Law on Finance (Decree 58 of 1998), which includes



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He started his career at the tax department of Iveco Fiat in Turin in 1988. He joined Gruppo GFT as group head of tax in 1989. From 1995 to 1998, Patrizio worked as international tax director at Pirelli Group. He then joined UniCredito Italiano Banking Group where he was appointed group senior tax executive. In 2012, he left UniCredit Group and started his experience at Paul Hastings Law firm in Milan. Since June 2019, he has been a partner at LED Taxand.

Patrizio has focused on tax risk control and monitoring, compliance from a tax and regulatory perspective, corporate governance for banks, as well as on “gap analysis” exercises, legal and tax advice to insurance companies, financial intermediaries and medium-sized service companies. He also worked on FATCA legal and Italian real estate issues. Patrizio provides assistance in litigation proceedings before the Italian Tax Courts.

investment funds that are resident in countries which allow the exchange of tax information with Italy.

For example, Cayman funds, credit funds or private equity funds, may benefit from an Italian mini-bond interest WHT exemption without any requirement of the look-through approach.

The only formal constraint is the submission of certain tax documentation.

This form of alternative financing should be seriously considered by private equity investors who might choose to set up a bridge shareholders loan for the first post-acquisition period, and then switch to a mini-bond financial structure.

Implementation of the Anti-Tax Avoidance Directives

The two EU Anti-Tax Avoidance Directives (ATAD), Directive 2016/164 and 2017/952, have been implemented in Italy by Decree No. 142 of November 29 2018, which entered into force in January 2019.

The ATAD introduces, inter alia, a different system of interest expense deduction, which was not in force when the Circular was issued.

Furthermore, the limitation of interest expenses to 30% of earnings before interest, tax, depreciation and amortisation (EBITDA), which generally speaking, was already in force in Italy, means that the ATAD has further restricted the right to deduct interest expenses.

In certain conditions where a hybrid mismatch is found (a hybrid mismatch may arise when an interest expense is deductible in the country of the payor and when the correspondent interest income is tax exempt in the hands of the recipient), the risk that the interest expense may become totally un-deductible in Italy, should be explored with the utmost care by foreign investors.

As of today, there is still limited practice, but the law is being analysed deeply by tax practitioners.

The only relevant existing exception is interest expense deriving from mortgage loans, which is deductible without any limitation.

Real estate-owned companies

Although the following is essentially referred to in the credit market, rather than the private equity market, we deem that in the course of time, some interest could be raised also for the latter.

Due to strong pressure from the European Central Bank (ECB) in the past three years, Italian banks have started a process of dismissing large portfolios of non-performing loans where the buyers have been institutional investors (mainly large international funds).

Many such portfolios were (and still are) related to mortgage loans on industrial and commercial real estate properties and, to a lesser extent, to residential property.

The scheme generally used to get rid of non-performing loans has been securitisation. The Securitisation Law (Law 130 of 1999) was amended and supplemented in 2017 (Decree No. 50 of April 2017, converted into Law No. 96 of June 21 2017) in order to address certain market developments.

Furthermore, Law No. 34 of April 30 2019 introduced striking updates with respect to real estate-owned companies (REOCOS) set up in the framework of securitisation transactions.

Real estate assets owned by REOCOS are held with the sole aim of enhancing credit recovery by investors in the securitisation notes and, under certain conditions set by the law, constitute segregated assets which benefit from a full tax exemption.

At the time of writing this article, the decree had not yet been converted into law, so the effectiveness of these new rules is not yet certain.

However, the trend is indirectly enhancing the Italian real estate market, also through the reduction/elimination of some tax burdens, which might ease the set-up of large REOCOS, and subsequently favour private equity in this sector.

Private equity in Italy

Looking back to the Circular, it remains certain that the guiding light of tax principles is to be applied to private equity transactions in Italy.

Based on the relevant developments and changes that have affected the Italian financial and tax environment, it could be worthwhile to reevaluate, reconsider and/or update private equity strategic investment decisions in Italy.



About us

LED Taxand is an Italian tax law firm with a recognised quality and high reputation of its professionals. With currently approx. 30 tax advisors and office in Milan, LED Taxand is the Italian member of Taxand (www.taxand.com), the world's largest independent tax organisation with more than 400 tax partners and 2.000 tax advisors in over 55 Countries. LED Taxand offers customized tax assistance, providing consultancy relating to direct and indirect taxes, fiscal and corporate aspects and opinions. The firm offers expert advice on tax and corporate issues related to extraordinary transactions.

LED Taxand operates in areas of general fiscal planning and structuring, tax compliance, real estate tax, indirect tax, International taxation and transfer pricing. The firm develops innovative solutions that allow the optimization of the tax framework and assists also in the phases prior to the conclusion of partnership agreements even through the activities of tax due diligence. For international groups such activity is carried out in partnership with Taxand.

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