Italian tax authorities' circular on LBO transactions

Highlights

- Increased certainty on interest deductibility in LBO transactions
- Tax authorities' attention on fees charged by private equity funds to portfolio companies
- Clarifications on interest withholding taxes in cases of indirect lending
- Increased attention on use of foreign vehicles

Italian tax authorities' circular on LBO transactions

On 30 March 2016 Italian Revenue Agency issued a comprehensive Circular ("Circular"), addressing the tax treatment of leveraged buyout transactions ("LBOs") and similar acquisition structures, with a particular reference to investments by private equity funds.
These guidelines will have to be taken into due account while structuring new acquisitions and assessing the need to revisit any existing structure to mitigate potential exposures.

1. Tax deduction of interest expenses

The recent practice of Revenue Agency was to challenge interest deduction in LBOs relying on different legal grounds (e.g. alleged lack of corporate benefit of the debt leverage, need for the acquisition vehicle to recharge the cost of debt to the shareholder under transfer pricing regulations or abusive nature of the transaction).
With the Circular, Revenue Agency reviewed its past approach and recognized that the allocation of interest at the level of the Italian acquisition vehicle has to be considered in general as a legitimate business expense that, if at arm's length, does not have to be recharged to the shareholder. Furthermore, the Circular indicates that the LBO structuring cannot per se be viewed as aimed at achieving an undue tax benefit, save for certain exceptions where abuse can be identified (e.g. in case of maintenance of control by the same, direct or indirect, shareholder).
This conclusion applies irrespective of whether the acquisition is followed by a merger of the acquisition vehicle in the target company or by a fiscal unity

between the two companies and irrespective of the residence of the shareholders (subject to the comments below regarding shareholder loans). Hence, the deductibility of interest expenses should in most cases be confirmed, so that – as the same Circular indicates – past claims should be reviewed by the competent offices. In line with such clarifications, the Circular also clarified that rulings aimed at obtaining the non-application of anti-avoidance rules in merger transactions for the carryforward of losses and non-deducted interests incurred will be evaluated more favorably.

2. Tax treatment of fees charged by private equity firms

The Circular also focuses on fees charged by private equity firms to the acquisition vehicle or the target company. Such fees are not deductible to the extent that they reflect activities conducted in the interest of the fund's investors (in such a case, no VAT charged on such fees will be recoverable). The Circular sets out a non-exhaustive list of criteria to test whether these fees reflect activities beneficial to the fund's investors (e.g. when they reduce the management fees charged to the fund's investors). Moreover, VAT on fees is not recoverable in any event if the exclusive activity of the acquisition vehicle was to hold shares without carrying on any other function, regardless of whether the acquisition vehicle is then merged with the target company.

3. Outbound interest payments

The Circular then contains an analysis of the possible withholding tax ramifications of the financing of LBOs when certain structures allowing a withholding tax exemption have been put in place.

a. IBLOR structures

The Circular addresses the financings structured in the form of "Italian Bank Lender of Record" loans (so-called IBLOR structures) where an Italian-based bank operates as fronting lender but shares the lending risk with non-Italian credit support providers. In the Circular, Revenue Agency clarified they will continue to challenge IBLOR structures when they are "not transparent", i.e. when the Italian fronting lender is not looked through for withholding tax purposes. Indeed, the Revenue Agency's position is that the credit support providers are considered the real recipients of the Italian-source interest. However, in such cases Revenue Agency indicates that, given the objective uncertainty on the interpretation of the case, penalties can be waived for violations committed before the issue of the Circular.

b. Indirect lending through non-resident vehicles

In case of indirect lending through assumption of external debt by a non-resident vehicle (associated with the investor carrying out the acquisition) that on-lends the financing to the acquisition vehicle, Revenue Agency in the past challenged the withholding tax exemption in principle applicable under the Interest and Royalties Directive due to the asserted lack of beneficial ownership (since the lending is seen as back to back). The Circular confirms that such structures will continue to be challenged with the consequent application of the tax regime applicable to direct financing by a non-resident non-associated entity to a resident company in all cases where the intermediate vehicle cannot be characterized, on a case by case basis, as beneficial owner or can be regarded as an "interposed" entity.

c. Applicability of specific exemption rules

With respect to both IBLOR structures and indirect financing, the Circular clarifies that the recently introduced withholding tax exemption regime on interest on medium-long term financing paid to EU established banks and insurance companies and white listed institutional investors should be applied in case of challenge of the above mentioned lending structures, thus preserving the exemption, if the conditions for its application are met.

4. Shareholder loans

The Circular further describes possible challenges made through the re-characterization of shareholder loans as injections of equity, with the consequent disallowance of the deduction of interest expenses.

In particular, according to the Circular, shareholder loans could be re-characterised as equity on a case by case basis in the presence – for instance – of the following elements:

- subordination of the capital repayment and interest payment of shareholder loans to the full reimbursement of third-party loans;
- the exclusion of the shareholder loans from the financial ratios defined in the financial covenants;
- the repayment of capital and payment of interests under shareholder loans is subject to contractual restrictions similarly to distribution of dividends and equity reserves.

The Circular clarifies that the re-characterization should be done in a fully-fledged fashion, thus treating re-characterized shareholder loans as equity increases for the purposes of the notional interest deduction (allowance for corporate equity or "ACE") and treating interest expenses as dividends for withholding tax purposes. Also in this case, the Circular opens to a waiver of penalties for the existence of objective uncertainty for violations committed before the issue of the same Circular.

5. Taxation upon exit disposals

The Circular indicates that Revenue Agency is aware that exit strategies generally contemplate the use, by foreign funds, of non-resident holding companies incorporated in tax friendly jurisdictions in order to minimize any tax leakage. In this respect Revenue Agency reiterates that the tax benefit so obtained could be disallowed in the absence of economic substance of such non-resident companies. In other words, the tax benefits will be disallowed when such companies act as conduit. This is a case by case analysis to be based on at least one of the following elements:

- a "light" organizational structure of the non-resident company; or
- the pure mirroring nature of sources and uses of the non-resident company.

In such cases, in absence of material non-tax reasons, the intermediate layers should be looked through and the tax benefit achieved disallowed. However, as clarified by the Circular, ultimate investors could (subject to the relevant conditions) claim the application of the tax treaties signed with their State of residence.

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