Italy – Tax authorities finally publish guidelines on LBO transactions. Glass half full

On 30 March 2016, the Italian tax authorities ("**ITA**") issued extensive (and long-expected) guidance on the taxation of inbound investments, in the form of LBO or otherwise (Circular n. 6 of 30 March 2016, the "**Guidelines**").

The Guidelines touch on a number of issues that have been heavily debated in the private equity industry in recent years and contain good and bad news. More in particular, the three areas addressed by the guidelines are:

- **Deduction of funding costs;**
- **Tax treatment of transaction costs;**
- **Tax treatment of outbound flows (dividends and interest); and**
- **Substance requirements of foreign holding companies.**

Here is the summary of the main positions by the ITA and how we see them.

Deduction of funding costs

The Guidelines acknowledge that **funding costs** incurred by the acquisition vehicle to finance the purchase of the shares of the target company **should in principle be regarded as legitimate business expenses**, both in the case of subsequent merger and in the case of tax consolidation between Bidco and target. Hence, the deduction of funding cost should not be disallowed *per se*, as a number of assessments by the tax authorities claimed over the years. The deduction of interest expenses remains subject to interest barrier rules (maximum 30% of adjusted EBITDA) and the application of the arm's-length principle. The various tax offices are hence invited to reconsider possible ongoing challenges, including in connection with debt push down transactions, in the light of the position set forth in the Guidelines.

Moreover, the limitation ordinarily applicable to the **carryforward of losses and interest expenses** in the framework of merger transactions should be weighted more benignly in relation to those acquisition vehicles that, by definition, would not pass the test to allow the carryforward of losses and interest expenses suffered between incorporation and the merger; the tax offices are hence invited to consider more favourably ruling applications aimed at lifting such limitations in the framework of genuine LBO transactions.

Special consideration should however be paid to those transactions whose sole or principal purpose is to allow the creation and deduction of funding costs or the carryforward of losses that would otherwise be unavailable. This could be the case, for example, on “captive” LBO transactions, where the seller and the purchaser are connected.

The Guidelines also address the "**arm's-length service**" argument that has been used by several tax offices to challenge LBO transactions. Under the argument, the Bidco was challenged as not having its own corporate purpose but existing as a mere agent of the foreign parent company to accomplish the acquisition of the Italian target company. As a consequence, the Bidco was expected to act at arm's length and charge the foreign parent an amount equivalent to the funding (and other) costs for the acquisition; thus resulting, de facto, in the disallowance of funding costs altogether. The Guidelines expressly state that this argument is not sound and the tax offices should consider dropping any outstanding challenge. Moreover, it is expressly stated that where the foreign parent actively participates in raising funds, it should be regarded as having provided an arm's-length service to the Italian Bidco and might be remunerated for the same.

Our view

The Guidelines are good news as they do away with the preposterous tax claims that had hit several transactions, disallowing interest deductions for many financial years and totalling enormous amounts of taxes and penalties claimed. Luckily, tax courts had shown a much more sensible approach and turned down several assessments. Now the tax authorities are expected to abandon any pending cases and affected companies should ensure that no effort is spared to secure the award of the relevant trial expenses.

Treatment of transaction costs

The Guidelines put transaction costs under the spotlight. Special attention should be paid to costs that are **charged directly to the portfolio companies** (or Bidco). In particular, it should be investigated whether such costs actually meet the business purpose test in relation to the specific company being charged, i.e. they reflect the benefit received by that company and not by other members of the group (or the investors). The key driver to consider disallowance should be to identify whether such costs are, *de facto*, a portion of the costs that the manager would ordinarily charge to investors (such as the management fees).

As to **VAT**, the Guidelines expressly state that where the Bidco is merely holding the shares, i.e. not providing any additional services to its subsidiaries (e.g. financing, advisory, etc.), any VAT charged on services it receives will not be recoverable, even after the merger. Similarly, neither will the recovery of VAT be allowed in connection with fees that are charged to the portfolio companies but that are, in substance, reflecting a benefit to someone else, such as the fund or its investors.

Our view

Charging transaction and management costs to active companies is not uncommon in the industry, to minimise tax (including VAT) leakage. The Guidelines do not provide any unexpected guidance on the subject. They make clear, however, that any tax audit on LBO transactions will contain a thorough review of the business rationale of the expenses charged to the (Italian) portfolio companies

Taxation of outbound flows

Through the Guidelines, the ITA have seized the opportunity to address their view on **IBLOR transactions**. In particular, the ITA state that the challenges for borrowers on failure to apply interest withholding taxes on IBLOR transactions should continue to be pursued (although without application of penalties), since the structure should be looked through and the credit support providers should be regarded as recipients of the Italian source interest

The Guidelines also address the application of the **withholding tax exemption** available between group companies under the Interest/Royalties Directive, which is normally invoked on any interest paid by the Italian Bidco to its foreign (often Luxembourg) parent. According to the ITA, the intragroup exemption shall not be allowed whenever the foreign parent is financing the Italian Bidco under back-to-back arrangements; the tax regime that should instead be applicable is the one applicable in the case of payment directly to the lenders of the foreign parent, under a full look-through approach (to be applied on a case-by-case basis). To this end, recently introduced withholding tax exemptions on interest (on medium-term loans) paid to eligible foreign lenders (EU banks and insurance companies, white listed institutional investors) should be taken into account, thus possibly ensuring that withholding tax exemption on interest is preserved.

In the case of **shareholders' loans**, the Guidelines highlight the fact that in certain (exceptional) circumstances such loans should be recharacterised as equity, thus leading to the disallowance of the relevant interest expenses. More in particular, the analysis should be based on the OECD arm's-length principle, to determine where the shareholders' money is provided is spite of the low creditworthiness of the borrower and serves, under a substance-over-form approach, as equity. More in particular, a shareholders loan might be recharacterised as equity when, for example:

- the shareholder's loan ultimately comes from investor's money (as normally happens);
- payment of interest and repayment of capital is junior to third-party debt;
- financial covenants of third-party debt treat shareholders loans as equity;
- payment of interest and repayment of capital is subject to the same constraints as provided for distributions of dividends and equity reserves.

Our view

The position towards IBLOR transactions is not new and the wording of the Guidelines is, in fact, already found in a number of tax assessments. While it is worth remembering though that Italian tax courts are generally not supporting the position of the ITA and are turning down its challenges, upholding the position of borrowers and lenders against the ITA, the Guidelines are a clear indication that the tax authorities will continue to pursue the court cases, possibly all the way up to the Supreme Court (meaning up to 10 years in total). Borrowers and sponsors should weigh their strategy and possibly consider thoroughly settlement options.

The opening towards the application of withholding taxes applicable to the ultimate lenders whenever an intermediate borrower is looked through is a welcome clarification. Although we have always considered this conclusion as a logical fall-back position in the case of look through of the foreign intermediate lender, this conclusion would have required extensive negotiation or litigation. That might no longer be needed following the Guidelines.

The position on shareholders' loans will have to be verified in practice. Although it marks a clear indication that tax audits will have to focus also on the possible recharacterisation of shareholders loans, these have become less frequent in recent years due to a possibility of securing a comparable tax benefit by injecting equity and taking advantage of the notional interest deduction. Greater focus by the ITA on shareholders' loans might make the use of full equity even more preferable. Moreover, as acknowledged in the Guidelines, the possible recharacterisation might not be overly penalising since, when the loans are recharacterised as equity, the notional interest deduction may become available.

Substance requirement of intermediate holding levels

Through the Guidelines, the ITA acknowledged that, upon exit, Italian source income in the form of capital gains or dividends would normally be channelled out of Italy through one or more layers of foreign (normally EU) holding companies, possibly through the use of profit participating instruments or other base erosion mechanisms. Any tax benefit so achieved should be respected unless it is obtained in the absence of the necessary **substance requirements**. Such requirements will not be deemed to have been met whenever a foreign holding company is acting as a mere conduit and this would be the case whenever:

- the foreign company has a very “light” organisational substance, with premises and personnel provided by specialised service providers and having little or no decision-making power as a matter of substance;
- the specific funding structure is organised so that Italian source income is channelled towards the fund through payments under instruments whose economic and contractual conditions allow the substantial matching of the outbound flows and inbound flows.

In such circumstances, absent any significant non-tax rationale, the intermediate holding layers should be disregarded and the tax benefits possibly achieved should be recaptured, looking-through the whole structure all the way up to the fund. Nevertheless, investors in the fund will be able to claim EU and treaty-based tax benefits possibly applicable to them directly if the fund (such as in the case of funds organised in the form of limited partnerships) is looked through for tax purposes in its jurisdiction of establishment.

Our view

This is certainly the most interesting and controversial bit of the Guidelines. It clearly shows that the substance of foreign companies will be under the spotlight. Given that several structures are indeed based on a relatively thin substance (regular meetings of more or less plausible boards of directors) and make extensive recourse to external service providers, it is reasonable to expect an increase in controversies. Sponsors should consider whether they should invest more in local substance, favouring actual decision-making power and seniority of human resources rather that the number of heads. It is also reasonable to expect a tougher stance towards structures set up by funds not established in white listed jurisdictions. Bearing in mind that the new list of white listed jurisdictions, that might be substantially wider than the current one, is expected in the coming days.

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