Executive summary

On 30 March 2016, the Italian Revenue Agency (IRA) issued important clarifications on (merger) leveraged buyout transactions (MLBO/LBO) via Circular letter 6/2016 (the Circular). The Circular clarifies that an Italian acquisition vehicle (SPV) may deduct interest expenses (within the limits provided by the law and transfer pricing provisions) incurred in the context of MLBO/LBO acquisitions either in the case of a subsequent merger with the Italian target or in the case of an election for tax consolidation. The importance of this interpretation resides in the fact that in recent years, the IRA has often challenged the deduction of interest paid in connection with loans granted to Italian acquisition vehicles by banks, shareholders and other lenders in the context of MLBO/LBO acquisitions. Challenges were mainly based on the assumption that such transactions represented abusive schemes since they were specifically aimed at deducting interest expenses against the income of the target entity, without a sound business purpose. Now the IRA takes the position that those structures should not be deemed as abusive since they are specifically governed by the Italian Civil Code and are often imposed by third party lenders.

The Circular also contains the following clarifications on MLBO/LBO transactions that might generally affect cross border structures involving the acquisition of an Italian target:
With reference to the merger of the SPV with the target, carry-forward limitations concerning tax losses and non-deductible interest expenses may be superseded by obtaining a positive tax ruling.

If a parent company raises funds on behalf of a group’s SPV set up to acquire a target, the parent company should be regarded as providing a service to the SPV with the latter paying an arm’s length fee to the former.

Allocation to the SPV or to the target of a portion of the management fees due by an investment fund to its private equity firm should be carefully scrutinized in order to avoid tax deduction issues.

Input valued added tax (VAT) on transaction costs (including the above fees), when applicable, may be deducted by the SPV only if certain conditions are met.

In the case of loans granted to the SPV through syndicated loans schemes (i.e., Italian Bank Lender of Record or IBLOR) having an Italian bank acting as the front entity, interest paid to the Italian bank should be subject to withholding tax as if interest were paid directly to the foreign lenders (saved for specific exemption regimes).

Interest withholding tax, instead of the European Union (EU) interest and royalties directive exemption, should also apply in the case of loans granted to the SPV through an EU holding company in the presence of back to back repayment structures.

Under certain circumstances, shareholders’ loans granted to the SPV may be re-characterized as equity with the relevant interest expenses being disallowed but with recognition of a Notional Interest Deduction (NID) where applicable.

In the case of lack of economic substance at the level of the EU/foreign holding company directly controlling an SPV, the EU parent-subsidiary directive exemption on dividends as well as the capital gain exemption provided under double tax treaties entered should be denied.

As a consequence, the relevant interest expenses have to be considered deductible either in the case of a merger or in the case of election of tax consolidation between the SPV and the target. The ordinary rules governing the deduction of interest (e.g., 30% earnings before interest, taxes depreciation and amortization (EBITDA) limitation) and general transfer pricing rules apply. This conclusion should be deemed valid also in the presence of non-Italian shareholders and/or non-Italian lenders. In this regard, the Circular invites the tax officers to revise the current assessments in light of this new approach.

Nature of the merger in the context of MLBO transactions

In the recent years, as acknowledged by the Circular, MLBO transactions have been challenged based on the fact that they were considered as an abusive scheme only aimed at the deduction of interest expenses incurred by the acquisition vehicles against the income of the target. In the view of the tax authorities, the merger between the vehicle and the target represented the evidence of this abusive behavior.

Now, the IRA has changed its approach by taking the view that mergers have to be seen as the natural conclusive phase of MLBO transactions and they are crucial for the repayment of the debt to the lenders. Merger transactions in MLBO contexts are also supported by business reasons, being specifically recognized by the Italian Civil Code and often imposed by third party lenders for financial purposes. In this regard, the Circular invites the tax officers to revise the current assessments in light of this new approach with the exception of specific situations of artificial arrangements, such as in the case of intragroup MLBO transactions.

According to the IRA, the non-abusive nature of MLBO transactions is also to be duly considered in evaluating specific Italian anti-abuse rules limiting the carry forward of tax losses and interest expenses in the case of mergers. In this respect, tax losses and excess of interest expenses at the level of the merging companies may be carried forward by the surviving entity only if the profit and loss accounts of each merging companies meet certain requirements (vitality test). Moreover, the carry forward is limited to the equity of each merging companies resulting from the last financial statement (or from the merger balance sheet, if lower), excluding any contribution made during the 24 months prior to the date of those statements (equity test). Should any of the above tests not be met, an advance tax ruling may be sought in order to supersede such tests.

Detailed discussion

Tax treatment of the SPV

After a detailed description of the MLBO/LBO transactions from a legal and technical perspective, the Circular focuses on the deductibility of interest expenses incurred by the SPV in connection with the amounts borrowed to finance the acquisition. The IRA preliminary clarifies that, from a legal and economic perspective, such debt should be deemed as sustainable on the basis of the complex requirements provided by the Italian Civil Code for this kind of transaction.
The Circular clarifies that both the vitality test and the equity test are not generally met by the acquisition vehicle in the context of MLBO transactions, being that such vehicle is often represented by a newly incorporated entity. However, in the case of mergers carried out in connection with an MLBO transaction, the IRA should give a positive answer to the ruling request under the assumptions that: (i) the initial equity injections received by the SPV should be considered normal in the context of an MLBO and, therefore, should be recognized for the purpose of the equity test, even if received during the 24 months preceding the merger; and (ii) the vitality of the vehicle should be deemed also in the absence of revenues, in light of its function played in the context of the MLBO transaction.

**Intragroup services rendered to the acquisition vehicle**

The Circular clarifies that if a parent company raises funds on behalf of a group's SPV, the parent company should be regarded as providing a service to the vehicle, to be remunerated at arm's length. Consequently, no remuneration for a service is due in the scenario where the vehicle has directly obtained the funds needed for the acquisition of the target.

Such a conclusion should prevent the tax authorities to challenge (to the SPV and/or to the MergerCo) the failure of recharge, from a transfer pricing perspective, of the interest expenses incurred for the purposes of the acquisition.

In this regard, the Circular invites the tax officers to revise the current assessments in light of this new approach.

**Tax treatment of fees charged to the SPV or to the target by the private equity firm**

The Circular outlines that the allocation to the SPV or to the target of a portion of the management fees (i.e., transaction/arrangement fees and monitoring fees) due by an investment fund to its private equity firm should be carefully scrutinized in order to avoid deduction issues. This is mainly aimed at avoiding situations where such fees are charged to the SPV or to the target and deducted from its income, while they would represent a cost to be borne by the investment fund or its ultimate investors.

According to the Circular, the attention of the tax officers in conducting audits on acquisition vehicles or target companies should be focused on certain specific clauses contained in the service agreements entered into between the above companies and the private equity firm, as follows:

- Clauses included in the limited partnership agreement, if any, providing the total or partial offsetting of the management fees due by the investment fund and the other fees recharged to the acquisition vehicle or to the target
- Contractual terms unreasonably in favor of the private equity firm and not in line with the market practice
- Clauses limiting the payment of the commissions to the private equity firms to the same limits provided by the loan agreements entered with third parties lenders (e.g., senior facility agreement and intercreditor agreement) for the distributions of profits
- Conditions included in other contracts or factual circumstances evidencing the presence, within the same MLBO transaction sponsored by two or more private equity funds, of one or more fees charged form different private equity firms in proportion of the participation held in the target

The IRA has concluded that the above fees should be deemed as not deductible if they are recharged to the target in connection with a service rendered by the private equity firm in the exclusive interest of the investment fund and its investors. In all other circumstances (i.e., the cost refers to a service rendered in the interest of the target), ordinary transfer pricing rules should apply.

Finally, the Circular clarifies that input VAT on the transaction cost (including the above fees) should, generally, be deemed as not deductible or refundable by the SPV, unless the latter actually carries on a commercial activity (that is, if it does not qualify as a static holding company). In fact, according to the European Court of Justice decisions, the mere holding of a participation, without an active involvement in the management of the controlled entity, is not deemed, per se, as an economic activity subject to VAT and, therefore, does not entail the deduction of the VAT applied costs incurred for the investment.

**Withholding tax on interest paid in connection with acquisition loans**

The Circular analyzes the withholding tax treatment applicable to interest paid in connection with two different types of acquisition loans:

- Syndicated loans schemes having an Italian bank as front entity (i.e., Italian Bank Lender of Record or IBLOR)
- Syndicated loans structures carried out through EU holding companies
An IBLOR represents a syndicated loan scheme having an Italian bank or an Italian branch of a foreign bank as a front entity which grants a loan to an Italian SPV/MergerCo and also enters into parallel agreements with foreign credit providers (banks, financial institutions and investment funds) to support part of the facility by means of cash deposit and guarantees. The front entity bears only part of the risk and profits of the loan granted being supported by other entities in the provision of the facility.

Market practice for the withholding tax treatment on interest payments was dependent on whether the IBLOR was transparent or opaque:

- In the case of transparent IBLOR schemes, the borrower applied the domestic or reduced treaty withholding tax on interest paid to the nonresident credit providers.
- In the case of opaque IBLOR schemes, the borrower did not apply any withholding tax on interest paid to the Italian bank, which in turn did not apply any withholding tax to the non-resident credit providers according to specific exemptions provided under Italian tax law.

The IRA confirmed the correctness of the tax assessments currently in place regarding opaque IBLOR schemes, clarifying that the interest paid by the Italian acquisition vehicle to the front entity should actually be subject to the withholding tax treatment applicable as if it were directly paid to the foreign credit providers. This approach should be adopted where the relevant documents (credit support agreement between the front entity and the credit providers, accounting and legal/other documents) and other factual circumstances evidence that the Italian bank is a merely interposed entity between the Italian acquisition vehicle and the foreign credit providers.

Risk of re-characterization of shareholders’ loans into equity

In certain circumstances, shareholders’ loans granted by foreign investors to the Italian acquisition vehicle/MergerCo should be re-characterized as equity based on the OECD TP guidelines (par. 1.64-1.67) and the relevant interest expenses should be deemed as not deductible.

The re-characterization of the shareholders’ loan as equity, in addition to not deductible interest expenses, may trigger the following tax implications at the level of the Italian acquisition vehicle/MergerCo:

- Re-computation of the NID benefit (provided that the anti-avoidance rules for NID purposes and general anti-abuse rules are met)
- Application of the withholding tax treatment on dividend distributions
Further, the IRA clarified that, with reference to the tax treatment applied by the taxpayer up to the date of the Circular, no penalties should apply due to the uncertainty of the tax treatment reserved to this matter.

Tax treatment of the exit scenario in terms of dividends and capital gain

In the final part of the Circular, the IRA focuses on the tax treatment of the exit from the investment which can be structured as follows:

a) Sale of the shares held in the Italian acquisition vehicle/MergerCo by a nonresident holding company

b) Sale of the shares held in the Italian acquisition vehicle/MergerCo by an Italian holding company and subsequent repayment of the cash to the nonresident holding company through dividends distribution

Such structures are generally characterized by a full tax exemption, in terms of: (i) capital gain protection under the relevant Tax Treaty, if any; (ii) exempted or reduced withholding tax applied on the dividend distributions under respectively the EU Parent-Subsidiary Directive and the relevant Tax Treaty; and (iii) partial or total exemption of the income at the level of nonresident holding.

According to the Circular, in principle, the results achieved through the above schemes should be considered legitimate when obtained utilizing genuine structures characterized by an adequate economic substance.

In this regard, specific attention should be paid to the economic substance of the nonresident holding company, which, according to the IRA, cannot be considered as adequate in presence of, either a:

- Limited organizational structure (personnel, equipment and premises are provided by third party management service suppliers), without actual and autonomous decisional powers (the company merely ratifies decisions taken by other group companies) - conduit company or artificial arrangement or

- Back-to-back financial structure, whereby the income received is immediately repaid to other companies under specific contractual obligations avoiding any withholding tax on the relevant payment - conduit transactions

In these circumstances, the Circular clarifies that, in the case of audit, all the above mentioned exemptions (e.g., provided by a Tax Treaty or by the EU Parent-Subsidiary Directive) can be denied.

Under the same approach, the reduced 1.375% domestic withholding tax applicable to dividends paid to EU residents subject to tax in their country of residence can also be denied.

In this regard, the IRA clarifies that the above challenge is valid although no specific anti-abuse rule is provided by the law, in the case of lack of adequate economic substance at the level of the EU holding company.

Finally, IRA clarifies that, in the presence of abusive schemes, the Treaty relief in terms of capital gain exemption should also be denied according to the OECD Commentary to the Model Tax Convention and to article 31 of the Vienna Convention on the law of treaties. However, the investors in the case of a tax transparent vehicle may try to obtain the recognition of the Tax Treaty in force with their country of residence, adopting a look-through approach based on the guidance provided by the IRA in this respect.

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Endnotes

1. Under Italian Civil Code, in the case of MLBO transactions: (i) the merger plan must indicate how the liabilities of the company resulting from the merger will be paid; (ii) a report issued by a third party appraiser must confirm that the statements in the merger plan concerning the financial means are reasonable; (iii) a report of an auditor (or of an auditing firm) must be attached to the merger plan; and (iv) a directors’ report must describe the economic reasons underlying the transaction including a plan describing the financial means and the goals to be achieved.

2. In particular, in the past, IRA used to challenge such transactions either arguing that the:
   a) MLBO/LBO acquisition qualified as an “abusive scheme” implemented for the sole/main purpose of deducting interest expenses in Italy
   b) Interest expenses did not qualify as costs related to the business activities of the SPV (“lack of inherence”)
   Or
   c) Interest expenses had to be recharged by the SPV to its foreign shareholder (i.e., private equity investor) according to an (in our view, incorrect) interpretation of the Organisation for Economic Co-operation and Development (OECD) Transfer Pricing (TP) Guidelines.
For additional information with respect to this Alert, please contact the following:

**Studio Legale Tributario in association with Ernst & Young, Milan**

- **Domenico Borzumato, International Tax Services**  
  +39 02 851 4503  
  domenico.borzumato@it.ey.com
- **Marco Magenta, International Tax Services**  
  +39 02 851 4529  
  marco.magenta@it.ey.com
- **Roberto Lazzarone, Transaction Tax**  
  +39 02 851 4325  
  roberto.lazzarone@it.ey.com
- **Savino Tatò, Transaction Tax**  
  +39 02 851 4511  
  savino.tato@it.ey.com
- **Quirino Imbimbo, Transaction Tax**  
  +39 02 851 4565  
  quirino.imbimbo@it.ey.com
- **Raffaele Villa, FSO**  
  +39 02 851 4386  
  raffaele.villa@it.ey.com
- **Paolo Zucca, FSO**  
  +39 02 851 4938  
  paolo.zucca@it.ey.com

**Studio Legale Tributario in association with Ernst & Young, Rome**

- **Emiliano Zanotti, International Tax Services**  
  +39 06 855 67383  
  emiliano.zanotti@it.ey.com
- **Nicoletta Mazzitelli, VAT**  
  +39 06 855 67323  
  nicoletta.mazzitelli@it.ey.com

**Studio Legale Tributario in association with Ernst & Young, Bologna**

- **Mario Ferrol, International Tax Services**  
  +39 051 278 434  
  mario.ferrol@it.ey.com

**Ernst & Young LLP, Italian Tax Desk, New York**

- **Simone De Giovanni**  
  +1 212 773 2351  
  simone.degiovanni@ey.com
- **Giulio Melillo**  
  +1 212 773 7348  
  giulio.melillo1@ey.com
- **Patrizia Pizzetti**  
  +1 212 773 4768  
  patrizia.pizzetti1@ey.com
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