Circular No. 6/E of 30 March 2016 clarifies certain tax issues of LBO transactions

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On 6 March 2016, the Italian tax authorities published Circular No. 6/E, providing guidelines on a vast number of tax matters connected to LBO transactions (the **Guidelines**). Although the considerations are quite general and wide in scope, the Guidelines are to be welcomed as positive innovation in the M&A market.

The Guidelines start with a brief overview of the most common features of LBO structures, including those in the context of private equity acquisitions (so called institutional LBOs). They then focus on, amongst other things, the deduction of funding and other acquisition costs and on the tax regime for outbound flows of income (i.e., dividends, interest and capital gains).

The Guidelines also provide clarification in connection with intercompany financing in LBO-like transactions through shedding some light on the so-called "substance requirement" and on the "look-through" approach.

1. Deduction of interest expenses and carry forward of tax losses accrued by Bidco

The Guidelines clarify that interest expenses on the acquisition debt incurred by a company incorporated for the purposes of carrying out the leveraged acquisition (**Bidco**) are, in principle, deductible, within the limits set out by article 96 of the Italian Tax Code. In addition, the Guidelines confirm that LBOs should not be automatically considered as tax abusive schemes.

As a consequence, tax offices are invited to reconsider pending assessments and dismiss those procedures which are not in line with the clarification provided in the Guidelines.

Furthermore, the Guidelines confirm that ruling requests aimed at demonstrating that certain anti-abuse provisions regarding mergers (limiting the carry forward of tax losses and interest expenses under certain conditions) are not applicable, should be considered more flexibly by tax offices, especially with regard to tax losses and interest expenses accrued by Bidco and by the entity resulting from the merger in the context of merger LBO (MLBO) transactions.

2. Private equity transactions including foreign entities – tax treatment of transaction costs (i.e., management and other fees)

Specific clarification is provided in connection with LBO transactions carried out by private equity funds.

In particular, the Guidelines highlight that fees charged by the fund managers to the target companies are deductible only to the extent that, after an in-depth analysis of the factual and contractual features of that transaction, they are proved to be related to services rendered exclusively for the benefit of the same target companies, and not to the fund or, ultimately, the investors.

If the costs are not deductible in the hands of the target companies then, according to the above mentioned principle, any related input VAT (where applicable) is not deductible.

Furthermore, the Guidelines clarify that input VAT charged on transaction costs paid by companies that are mere holding companies (i.e., companies the activity of which is limited to holding shareholdings) is not deductible.

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3. Re-characterization of shareholders' loans as equity contributions

The Guidelines also clarify the circumstances in which shareholders' loans advanced by foreign entities to Italian Bidcos, in the context of LBO transactions, may be re-characterized from a tax perspective as equity contributions. As a consequence of any such re-characterization, the deduction of interest expenses paid on the loan will be disallowed and the dividends' tax regime to the respective flow of income applied.

In particular, a re-characterization may be grounded, for example, on an apparent inconsistency between the legal form and the economic substance of the financing scheme in circumstances where, given the financial situation of the financed company (Bidco), it appears that a third, independent, party would not have advanced funds in the form of debt.

The Guidelines emphasize that the relevant tax office must be able to show that the economic purpose of the transaction is debt financing.

In relation to assessments on past transactions, no penalties should be applied.

4. Tax regime for outbound flows of income (i.e., dividends, interest and capital gains)

The Guidelines also focus on the tax regime for outbound flows of income derived from these types of transactions (typically in the form of dividends and capital gains), and shed some light on the substance requirements of foreign holding companies for the purposes of the application of certain tax provisions.

In particular, the Guidelines clarify that relief under the anti-double taxation treaties concluded by Italy (especially in relation to capital gains) and European tax directives (in particular, the Parent/Subsidiary Directive) will not apply to artificial structures the main aim of which is minimizing the tax impact of the investment and, eventually, of the divestment.

Examples of this, according to the Guidelines, are when any of the companies involved in the transaction – at all levels of the chain right up to the investors – is not substantiated enough or has not got a sufficient connection with the country where they are located in terms of their business activities or does not retain enough rights and powers over the flow of income received by the Italian companies. In these cases the company should, therefore, be considered a pure conduit company.

In such a scenario, in the absence of any significant non-tax reasons for the use of an intermediate layer between the fund and the Italian Target, the tax authorities could claim taxes both on any capital gains deriving from the sale of the shareholdings and on dividends distributed to EU holding companies.

Finally, the Guidelines seem to corroborate an earlier interpretation of the "look-through" approach for tax transparent entities, allowing, in specific circumstances, investors in tax transparent funds to claim direct application of the treaty and other benefits depending on their country of residence and tax status.

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