

Private Equity – New Legislative Provisions Concerning the Italian Tax Treatment of the Carried Interest

On 11 April 2017, the Italian Government issued Law Decree No. 50 (the “Decree”), which was published in the Official Gazette on 24 April 2017¹. The Decree sets out important rules concerning the characterization, for the purposes of Italian income tax, of income derived from participating in collective investment funds (CIV), companies or entities, by individuals who, in addition to qualifying as investors, manage the CIV, the company or entity. This is called “carried interest”.

1. Why is the classification of carried interest important?

The classification of carried interest has always been subject to debate because carried interest could in principle fall either under the scope of income from employment/self-employment or income from capital/other income. As the Italian tax treatment of income from employment/self-employment and income from capital/other income differ significantly, it is very important to identify the correct characterization of carried interest for Italian tax purposes.

In both domestic and international scenarios, the classification of carried interest as income from capital/other income leads to a lower tax burden than if the carried interest is classified as income from employment/self-employment. In principle, income from capital/other income received by Italian tax residents is subject to a 26% final withholding tax while income received by Italian residents from employment/self-employment is fully taxed at the individual's marginal rate (up to 43% plus local surcharges); in addition, the employer would be required to act as withholding tax agent in connection with such income.

2. Classification under Article 60 of the Decree

Article 60 of the Decree solves the issue by setting out the conditions to be fulfilled for the carried interest to qualify as income from capital/other income and to be taxed accordingly. The Article 60 applies to

- a. Italian and non-Italian tax resident individuals who are directors or employees of the CIV (or its asset manager), the company or the entity,
- b. proceeds deriving from investments in:
 - i. CIVs, companies and entities resident/incorporated in Italy (shares, quotas and other financial instruments granting the investors special financial rights), and
 - ii. CIVs, companies and entities resident/incorporated in a country other than Italy provided that that country allows for an adequate exchange of information with Italy.

If the conditions provided for in Article 60 are not met, then the carried interest may be treated as income from employment/self-employment and subject to ordinary income tax at the investor's marginal rate (advance withholding taxes must be levied by the employer on the income from employment/self-employment).

¹ Official Gazette, *Serie Generale*, No. 95, on 24 April 2017¹ - *Suppl. Ordinario* no. 20

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Pursuant to Article 60, for income to qualify as income from capital for the purposes of Italian income tax all the following conditions must be met:

- a. the overall committed investment of the employees/directors must be equal to at least 1% of the total capital invested in the CIV or 1% of the net-worth equity of the company or entity ("**Investment Threshold Requirement**").
Investments made by employees/directors in shares/quotas that do not grant special financial rights, are included in the calculation of the Investment Threshold Requirement.
- b. the income deriving from the investment in CIV/shares/quotas/other financial instruments granting special financial rights only accrues and become payable only after all the other investors in the CIV/company/entity have received an amount equal to the invested capital plus a floor yield provided for by the company or entity by-laws or by the CIV's regulations (if any) ("**Distribution Hierarchy Requirement**").
If there is a change of control, in order for the Distribution Hierarchy Requirement to be met, the purchase price received by the investors (other than the relevant directors and employees) from the sale of the shares/quotas must equal the invested capital plus a floor yield provided for by the by-laws/CIV's regulations (if any).
- c. the relevant directors/employees (or their heirs in the case of death of the relevant investor), must hold the shares/quotas/financial instruments with special financial rights for an uninterrupted period of at least 5 years ("**Holding Period**"). If a change of control occurs during the mentioned time span, the Holding Period is met if the shares/quotas/financial instruments are held until the day when the change of control occurs.

For the purposes of the Investment Threshold Requirement, the following elements must also be taken into account:

- a. the amount subject to tax in the hands of the Italian resident directors and employees as employment income arising from any assignment of the shares, quotas or other financial instruments;
- b. the amount that would have been subject to tax in the hands of the non-Italian resident directors/employees as employment income arising from any assignment of the shares, quotas or other financial instruments, if such individuals qualified as Italian resident individuals.

The provisions laid down in Article 60 of the Decree apply to income deriving from shares, quotas and financial instruments granting special financial rights (regardless of their date of issuance/purchase/assignment) received by qualifying investors from 24 April 2017.

The Decree will only be effective if it is converted into Law by the Italian Parliament by 23 June 2017. The converting law may amend the provisions of the Decree.