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Direct lending - Tax exemption regime provided for outbound interests related to some medium/long-term loans granted by foreign institutional investors to Italian legal entities. New opportunities for investment funds?

1. Introduction

As a general rule, outbound interests paid by Italian companies to foreign legal entities are subject to a 26% Italian withholding tax *ex* article 26 paragraph 5 of Presidential Decree n. 600/1973.

The Law Decree n. 91/2014 amended the above mentioned general tax regime, introducing (through the new paragraph 5-*bis* of article 26 of PD n. 600/1973) a special tax exemption regime applicable to some interests paid by Italian legal entities in favour of some foreign financial entities. From a tax perspective, this regime represents an innovation for the Italian tax system, as it provides a full tax exemption for interests expenses arising from some financial loans granted by foreign legal entities to Italian companies, not linked to participation relationships.

The rule in hand was amended several times in recent years and the final version currently in force, after the amendments provides by Law Decree n. 18/2016, states that, assuming the respect of the regulatory rules provided by the Italian Bank Law (*i.e.* TUB) in relation to the professional lending activities in favour of third parties, the 26% withholding tax is not levied in case of interests arising from medium/long-term loans granted to Italian legal entities by some foreign financial institutions located in EU/white-listed countries.

The main purposes of the Italian Tax Legislator were aimed at simplifying access to foreign lending for the Italian legal entities and at eliminating some cases of legal double taxation of outbound interests, whose costs are usually recharged to the borrower from the lender, through specific agreements or contractual clauses.

The mentioned exemption tax rule must also be read taking into consideration the current necessity to grant the same tax treatment to financial loans granted by Italian financial institutions and by foreign ones, in order to lead to higher competitiveness in the sector.

2. The tax exemption regime and conditions to comply with

On the basis of the current version of the tax rule described above, the exemption regime is applicable only if the following conditions are jointly met: (i) regulatory requirements stated by Italian Bank Law in relation to the protected lending activity (ii) subjective requirements in relation to the legal form of the lender and (iii) objective requirements related to the legal form of the financial loan.

With regard to the first condition, the tax rule states that the tax exemption regime is applicable only if the regulatory requirements stated by the Italian Bank Law (related to the reserved and protected activities of lending and financing carried out with independent third parties) are properly met. This provision was introduced by Law Decree n. 18/2016 as in Italy the financial entities could not perform a professional lending activity without a specific authorization issued by the Italian Central Bank.

The second condition is related to the legal form of the lender that should have one of the following forms: (i) financial institutions resident in EU countries in accordance with the provisions stated by art. 2 par. 5 n. 4-23 of the EU Directive 2013/36, (ii) insurance companies incorporated and authorized under the relevant local EU law or (iii) foreign institutional investors located in white-listed countries, although not liable to tax in their relevant country of residence, but subject to regulatory audits in the country in which they are incorporated.

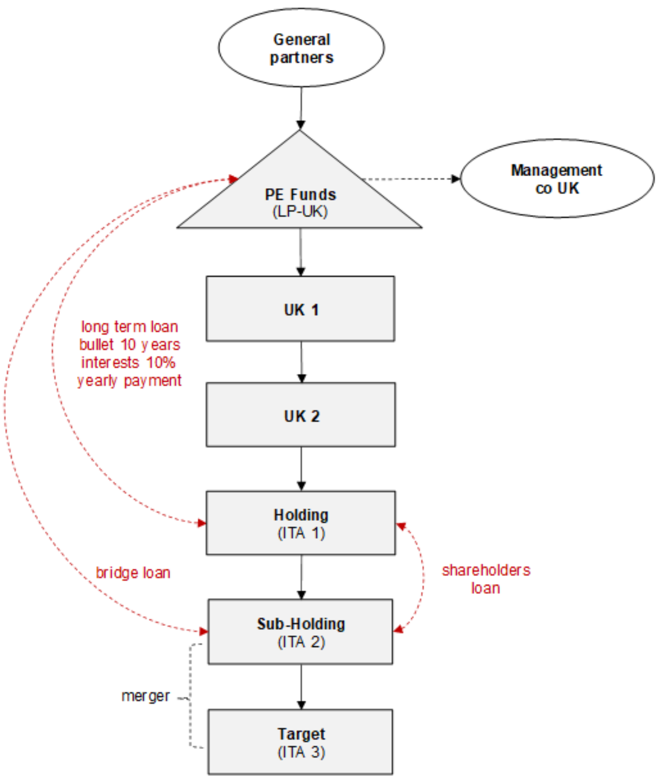
The last condition, in order to obtain the mentioned tax advantage, requires that interests must arise from medium-long term loans granted to Italian companies.

3. Tax ruling clarifications

The Italian Tax Authority (hereinafter also “ITA”) analyzed the perimeter of the tax exemption regime, provided by Article 26 paragraph 5-*bis* of PD 600/73, in a private ruling published by the specialized press in previous months.

The ruling was filed by the management company of some UK investment funds, in order to check if the tax exemption regime in hand was applicable also in relation to interest expenses arising from a 10 year loan granted by the UK investment funds to their indirectly controlled Italian legal entity.

Here below is a summary of the investment structure described in the ruling:



Based on the information reported in the tax ruling filed, the management company was a legal entity authorized and audited under the relevant financial regulatory authority in UK (*i.e.* FCA), while the investments funds were incorporated under the legal form of UK limited partnership and they were registered on the basis of the Limited Partnership Act 1907 (hereinafter also “PE Funds”).

In order to perform the acquisition of an Italian target, the PE funds set-up an Italian holding company (ITA 1) indirectly controlled through their subsidiaries (UK1 and UK2). ITA1, in turn, fully controlled another Italian Sub-Holding (ITA 2) which fully hold the stakes of the target-co (ITA 3).

The acquisition was financed by the PE Funds by granting to the Holding-co ITA1 a 10 year financial loan (10% interest bearing on a yearly base). The PE Funds also granted a bridge loan to the Sub-Holding ITA 2.

On the above premises, the management company asked ITA for some clarifications about the applicability of the above mentioned tax exemption regime to interest expenses paid by Holding-co ITA 1 to PE Funds.

ITA confirmed that the tax exemption regime provided by par. 5-*bis* of art. 26 of PD 600/73 was applicable in relation to interests arising from the medium-long term loan granted by the PE Funds to ITA1 (the bridge loan was not treated by ITA), for the following reasons.

First of all, ITA clarified that the application of tax exemption regime is always subject to the respect of the regulatory bank framework in relation to the professional lending activity. However, ITA pointed out that the protected lending activity is carried out "*whenever it is performed in favor of third parties on a professional basis*" while "*all activities performed exclusively in favor of its own group*" are out of the scope of the regulatory Italian Bank Law. In other words, the lending activity performed by an investments fund in favor of the legal entities of the same group are excluded from the scope of this limitation. This aspect, probably, represents the most important clarification pointed out in this respect, as it could have a great influence on the financing strategies of Investments funds by supporting the direct lending to the investment vehicle set-up in order to carry out the acquisition of the target companies.

Secondly, ITA clarified, inter alia, the meaning of "foreign institutional investor" by specifying that is "*the entity which, regardless of the legal form and of the tax treatment applicable in the country in which it is incorporated, has, as corporate purposes, the execution and management of investments for itself or on behalf of third parties*". In order to get the tax exemption, the foreign institutional investor should meet the following conditions: (i) it must be located in a white-listed country with which ITA has in place an information exchange program and (ii) it must be subject to a regulatory audit by the local financial authority in compliance with the relevant regulatory law applicable. ITA has pointed out that this second condition should be checked indifferently at the investment entity level or at the management entity level (i.e. the management company in case of investment funds).

As a final consideration, ITA clarified all doubts related to the meaning of "medium/long term loans", stating that the tax exemption regime is applicable in relation to financial loans with a mandatory minimum duration higher than 18 months and one day, and only in relation to loans granted to entities which actually carry out in Italy a business activity as provided by art. 73 par. 1 lett. a) and b) of the Italian Tax Code.

4. Conclusions

The above mentioned new tax exemption regime could have, on one hand, a significant influence on institutional investors eligible for the tax exemption, and, on the other, it could represent a great opportunity to foreign investment funds to set-up new investment/financing structures (direct lending) in order to finance their acquisitions, and, in the meantime, could support the access to new competitive financial sources for Italian legal entities.

As a matter of fact, the application of the current tax exemption regime seems more simple, immediate and attractive for investment funds and should allow them to be in a position to finance directly the investment vehicle set-up in order to perform the acquisition of the relevant target.

In conclusion, this tax regime represents an additional opportunity for both Italian entities to get new financial resources and for foreign investment funds to develop the direct lending strategy in order to finance their own acquisitions.