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New Guidance Sheds More Light on Italian Carried Interest Tax

Following the approval of the new rules regarding taxation of carried interest proceeds enacted with Law Decree No. 50/2017 (Decree), the Italian Tax Authorities issued specific guidelines with Circular Letter No. 25/E, dated 16 October 2017 (Circular Letter).

The Decree established that proceeds realised from units/interests having special economic rights (*diritti patrimoniali rafforzati*) (eligible instruments) issued by Italian-resident or whitelisted collective investment vehicles (CIVs), companies and entities shall always be treated as income from capital, regardless of the existence of an employment relationship with the carry holder, provided that the following conditions are met:

- Carry holders (which include any directors and/or employees of entities which have a direct or indirect control, management or advisory relationship with the issuers of the eligible instruments) shall commit themselves to actually invest, and have an actual disbursement thereof, an amount at least equal to 1 per cent of the total amount invested by the CIV, or the net equity of the relevant company or other entity.
- Proceeds from the eligible instruments shall be payable only if all investors have received (1) full reimbursement of the invested capital and (2) a certain return (hurdle rate) provided under the relevant regulations.
- A five-year minimum holding period shall be fulfilled, or, in the case of a change of control, the eligible instruments shall be held until the date such change of control occurs.

In determining the 1 per cent threshold mentioned in the first point above, the following shall be taken into account:

- Ordinary units/interests issued by the CIVs, companies and entities that are held by all carry holders (including units which do not grant any preferential economic rights, *i.e.*, ordinary units/shares)
- Units/interests attributed to the carry holders as a benefit in kind and taxed as employment income

Proceeds from CIVs are subject to substitutive taxation applied at a 26 per cent rate if the carry holders participate in Italian investment funds set up according to the Italian regulatory framework, or in EU/EEA alternative investment funds managed by alternative investment fund managers subject to regulatory supervision according to the EU AIFM Directive. In all other cases, proceeds from CIVs shall be taxable at a progressive personal income tax rate (*e.g.*, equal to 43 per cent on taxable income exceeding EUR 75,000).

Upon assignment (*i.e.*, subscription/acquisition) of any eligible instruments, the difference (if any) between the fair market value of the units/interests subscribed by the carry holders and the actual consideration paid for the subscription/acquisition will be treated as a benefit in kind and taxed as employment income at a progressive personal income tax rate (*e.g.*, equal to 43 per cent on taxable income exceeding EUR 75,000).

The Circular Letter provides useful clarifications on the following matters related to the Decree.

The 1 Per Cent Minimum Investment Threshold

The Circular Letter clarifies that the eligible instruments subscribed by any person other than the carry holders shall not count for the purpose of verifying the 1 per cent threshold (para. 3.1). In making this

clarification, the Circular Letter expressly excludes from the above computation the units and shares subscribed by any individual who has an advisory contractual relationship with the CIV or company, even if such person is a "risk taker" for regulatory purposes and therefore subject to the guidelines and limitations provided by the ESMA remuneration policies. However, the units/shares subscribed by an employee/director of an advisory company of the CIV or company, who indirectly participates in its operating activities, shall be considered in the verification of the minimum threshold.

The Decree states that "the commitment of the Carry Holders must entail an actual disbursement equal to at least 1% of the amount invested by the CIV or 1% of the net equity of the company". With regard to CIVs, reference should be made to the capital invested, including expenses attributable to the CIV and net of any third-party leverage. In other words, the carry holders' disbursement must be proportioned to the capital actually invested by the other investors, rather than to the amounts employed to acquire the underlying investments, which usually include a substantial financing (para. 3.1 of the Circular Letter).

The Decree does not specify when the 1 per cent threshold must be verified. The Circular Letter suggests that, consistent with the operating structure of an investment fund, such verification should occur at the end of the subscription period, when the proportion of the commitment structure of the investment scheme (typically a closed-end reserved alternative fund) is finalised (para. 3.1, lett. a).

The Circular Letter further clarifies that once the 1 per cent threshold is verified, if some of the units/shares are transferred by means of succession to a person other than an employee or director, or an employee/director terminates his or her employment/directorship relationship, there will be no consequences for the remaining carry holders even if the overall interest falls below 1 per cent.

The fulfilment of the 1 per cent minimum investment shall be certified by the CIV or the entity which issued the eligible instruments, according to the Circular Letter.

The Decree makes reference to direct or indirect participation in eligible instruments. Accordingly, the Circular Letter states that where eligible instruments are held through a special purpose vehicle or subscribed by a management company in which the carry holders participate, such indirect participation will be counted for the purposes of the 1 per cent threshold, on the basis of the *pro quota* attributable to the carry holders. Eligible instruments held by entities—including the management company—in which carry holders do not participate shall not be considered for the purposes of determining the 1 per cent threshold.

Repayment Subordination

The Circular Letter clarifies that the repayment subordination condition is not intended to limit the carry holders' right to receive their invested capital back and their share of the hurdle rate after repayment of the same amounts to the other investors (para. 3.2). Indeed, the Italian Tax Authorities acknowledge that carry holders will be remunerated for the amount invested and their proportionate share of profits alongside the other investors; only that part of non-proportional proceeds (*i.e.*, the carried interest) must be subordinated in order to satisfy the regime at hand.

Holding Period

The Circular Letter clarifies that the five-year holding period shall be determined starting from the end of the subscription period for CIVs, and from the date of subscription of the capital injection for entities other than CIVs.

In case of transfer of the units/interests within the five-year period (*e.g.*, a change in members of the management team), a new holding period shall start from the date of change of ownership for the incoming carry holders.

The existence of the holding period condition does not imply that carried interest proceeds distribution shall be deferred until the end of the holding period, according to the Circular Letter (para. 3.3). If the eligible instruments are sold, however, before the five-year period and the proceeds distributed are characterised as employment income, additional taxes, penalties and interest would be applicable to the carry holders.

Finally, the Circular Letter clarifies that the holding period requirement also applies to ordinary units/interests issued by the CIVs, companies and entities and held by all carry holders.

Subscriptions of Eligible Instruments into "Companies"

The Circular Letter provides useful comments on the application of the Decree when the eligible instruments are issued by a company which does not qualify as a CIV.

In line with the literal wording of the Decree, the proceeds paid out from shares that grant non-proportionate economic rights shall qualify as income from capital under the conditions set out above, regardless of whether the issuer is a company held by a private equity firm (para. 2.2 of the Circular Letter).

The Circular Letter states that in order to verify the minimum threshold condition for entities other than CIVs, reference shall be made to 1 per cent of the entity's post money net equity (*e.g.*, the implicit net equity valuation at the date of carry holders' capital injection or interests acquisition), adjusted for any further investment in the company by other investors.

Other Clarifications

The Circular Letter clarifies that once all the conditions set by the Decree are met, the qualification of the proceeds from the eligible instruments as income from capital would not be affected by any (good or bad) leavership clause (para. 4).

The Circular Letter also provides general comments with regards to qualification of eligible instruments proceeds in case the Decree requirements are not met. Under such circumstances, the carry holders may submit a ruling request to the Italian Tax Authorities in order to confirm the tax treatment of their carried interest schemes. In general, the financial nature of the proceeds may be supported by the actual risk of loss of the invested capital, the presence of similar instruments held by other investors (especially in case of large CIVs), or an adequate compensation package compared to the industry standard. In particular, the possibility for the carry holders to retain ownership of the units/interests even after the triggering of leavership clauses may be considered sufficient proof of the financial nature of the instrument, even if none of the conditions set by the Decree are met.