

*Tax and Legal Issues, April 2018*

*By Roberto Egori and Toni Marciante (Freshfields Bruckhaus Deringer LLP)*

**Private Ruling no. 954-127/2017:**  
**availability of the notional interest deduction on equity injections**  
**in the context of private equity transactions**

*Private Ruling no. 954-127/2017*

1. The fact pattern considered by the Italian tax authorities (the *ITA*) in Private Ruling no. 954-127/2017, as shown in Figure 1 below, may be summarised as follows:

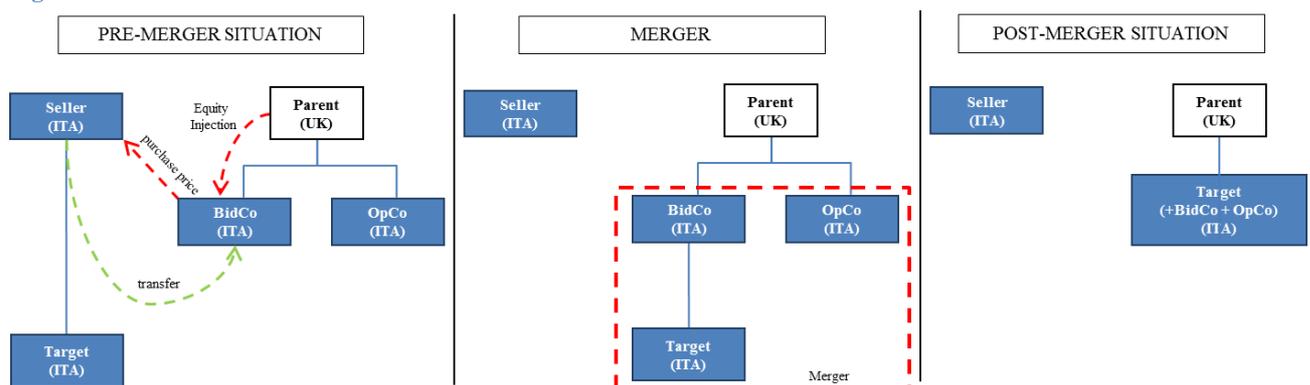
(i) an Italian company (*BidCo*) is incorporated in Italy by a UK parent company in order to perform the acquisition of an Italian target company (*Target*);

(ii) BidCo receives equity contributions of Euro 62.5 mln by its shareholder (the *Equity Injection*);

(iii) at the beginning of 2016, BidCo acquires 100% of Target's share capital and, on 24 November 2016, BidCo is merged into Target, with legal effect starting from 1 December 2016, together with another Italian subsidiary of the UK group (*OpCo*). The merger is implemented with a view to simplify the structure of the group in Italy.

2. As a consequence of the merger, Target *inter alia* inherits the right to the Italian domestic notional interest deduction benefit accruing on the Equity Injection (so called *ACE Benefit*). As a consequence, the ACE Benefit accruing in respect of the Equity Injection could be used to offset the possible future taxable income of Target after merger.

Figure 1



3. Against the above background, Target filed a ruling request with the ITA to obtain confirmation that the availability of the ACE Benefit after merger should not be challenged under the Italian general anti-abuse tax provision set out by Article 10-bis of Law no. 212 of 27 July 2000 (the *Article 10-bis*).

4. With Private Ruling no. 954-127/2017, the ITA confirmed that the ACE Benefit available to Target as a result of: (a) the incorporation of a vehicle aimed at the acquisition of a target company funded with equity injections; and (b) the following merger of such vehicle with the target company should not amount to an “undue tax benefit”, as further discussed in the following paragraphs.

*The Italian domestic tax laws on notional interest deduction: brief remarks*

5. Under Italian tax laws, Italian companies are allowed to deduct, for corporate income tax purposes, a notional interest (i.e. the ACE Benefit), which is determined by applying a nominal 1.5% rate on the cash equity injections made by its shareholders and on any retained earnings (the **ACE Base**).

6. For Italian companies established from 2011 onwards, the equity contributions made by the relevant shareholder upon incorporation in principle concur to determine the ACE Base, subject to a number of detailed provisions (e.g. pro rata temporis basis rule, etc.). The ACE Base is then increased to take into account any additional equity contributions in cash (even if made in the form of waiver of financial receivables) and any retained earnings, and should be decreased of any distributions of equity and/or profits.

7. The availability of the ACE Benefit is subject to a number of specific anti-abuse tax provisions aimed at avoiding double-counting of equity injections within the same group. For instance, the ACE Base should be determined net of cash contributions ultimately injected by entities domiciled in Countries which are not included in the so called Italian White List, and a full look through approach must be applied to ascertain whether the ultimate investors are tax resident of a Country included in such Italian White List.

8. If a company is part of an Italian tax group, the ACE Benefit that cannot be offset at individual level in a given tax year, due to a lack of tax capacity, may be used within the tax group to the extent that: (a) there is spare tax capacity at the level of the tax group; and (b) the ACE Benefit has been generated after the inclusion of such company within the tax group. Any excess ACE Benefit can be carried forward.

*The Italian domestic general anti-abuse provision: brief remarks*

9. Article 10-bis mentioned sets out the Italian general anti-abuse tax provision. In particular, under Article 10-bis, the tax benefit generated as a result of the implementation of a transaction qualifies as abusive and should consequently be denied, if all of the following three requirements are met:

(i) the transaction lacks of economic substance. This is the case when the transaction is implemented in an “artificial manner”, involving legal instruments and corporate steps which would not have been adopted, if it was not for the relevant tax benefit they can offer;

(ii) the transaction, while formally consistent with tax law, generates “undue tax benefits”, i.e. tax benefits which do not reflect the underlying principles and rationale of the Italian tax laws; and

(iii) the tax benefit is the essential effect of the transaction.

*Private Ruling no. 954-127/2017 and private equity transactions: preliminary remarks*

10. The transaction considered by the ITA with Private Ruling no. 954-127/2017 generates a tax benefit in the hands of Target. In particular, the incorporation of a new company (BidCo), the injection of new equity into BidCo, the acquisition of Target by BidCo and the subsequent merger of BidCo into Target, enable Target to inherit the ACE Base of BidCo, which could generate an ACE Benefit to be possibly offset against the positive taxable income generated of Target in future years, if any. Had the foreign UK parent directly acquired Target on a cross-border basis, without incorporating BidCo, the mentioned tax benefit would have not been available to Target.

**11.** The conclusion reached by the ITA in Private Ruling no. 954-127/2017, as mentioned sub point 4 above, is based, *inter alia*, on the following circumstances:

- (i) the purchase price paid by BidCo to the seller of Target is not then returned or otherwise retransferred (by way of equity contributions or loans) to entities part of the acquiring group;
- (ii) the transaction at stake (i.e. injection of equity into BidCo and subsequent merger of BidCo into Target) implies an actual increase of the net equity of Target after merger, and hence achieves an outcome which is in line with the rationale of the Italian tax laws governing the ACE Benefit.

**12.** The conclusion reached by the ITA with Private Ruling no. 954-127/2017, whereby the choice to invest through an Italian vehicle rather than performing a direct cross-border acquisition, is not abusive also reflects the fact that this is a transaction which is not implemented in an “artificial manner”, since it involves legal instruments and corporate steps which are normally adopted in the private equity market. This is an aspect already confirmed in the past by the ITA<sup>1</sup>.

**13.** The conclusion reached by the ITA with Private Ruling no. 954-127/2017 is in line with the view expressed by the second degree tax court of Milan (see Decision no. 192/6/2018 of 22 January 2018) on a fact pattern similar to the one at hand.

**14.** The conclusions adopted by the ITA in Ruling no. 954-127/2017 with respect to the ACE Benefit is also consistent with the guidelines issued by the ITA with Circular Letter no. 6/E of 30 March 2016 on merger-leveraged buy-out transactions, whereby the ITA has confirmed the deductibility of the interest expenses accruing on the acquisition debt incurred by an Italian acquisition vehicle (i.e. BidCo) to perform the acquisition of an Italian target company.

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<sup>1</sup> With Ruling no. 39483 of 22 August 2001, addressing a transaction involving a foreign investor acquiring shareholdings in Italian companies, the ITA confirmed that “*the main objective of the Finnish company is the acquisition of a controlling stake in two Italian companies <<BETA>> e <<KAPPA>>. In order to implement such transaction, the mentioned company has two alternatives: [a] directly acquire the stake in the two Italian companies; [b] perform the acquisition through a newly established Italian sub-holding (ALFA). The choice to implement one of the two option is, in the view of the tax authorities, a legitimate entrepreneurial choice that the tax and economic system cannot deny. In other words, it is a choice allowed by the system*”.