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Associazione Italiana del Private Equity, Venture Capital e Private Debt

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Tax and Legal Issues, October 2018

by Luca A. Pangrazzi and Matteo Poletti (Fieldfisher)

VAT deductibility of transaction costs incurred in the context of leveraged buyouts - latest European positions and potential effects on the Italian Tax Authority's view as expressed in Circular Letter No. 6/E of 30 March 2016

As is known, with Circular Letter No. 6/E of 30 March 2016**,** the Italian Tax Authority provided important clarifications regarding the tax issues involving leveraged buyout transactions, which helped provide more tax assurances to the entire private equity market. The above mentioned document has not however cleared up all interpretative doubts associated with these transactions and, indeed, in some cases contributed to increasing the uncertainties of the professionals in the industry. We refer specifically to the doubts (i) on investment structures' effective sustainability of international funds that invest in Italy by establishing EU holding companies, (ii) on the tax treatment applicable to the "exit" phase performed by the abovementioned EU holding companies, (iii) on the VAT deductibility of the transaction costs incurred by the investment vehicles (also called "Special Purpose Vehicle", "SPV", "Newco" or "Bidco"), (iv) on the need to file the tax ruling in order to avoid tax limitations provided by Article 172, paragraph 7, of the TUIR (i.e. Italian Tax Law) after Bidco and target's successful merger, (v) on requalifying shareholders' loans as equity contributions, (vi) on LBO transactions in which are involved parties that already control the target and on the LBOs implemented on minority interests, etc. These uncertainties have led AIFI to submit to the representatives of the Italian Tax Authority its observations concerning the above mentioned Circular Letter No. 6/2016 in order to settle the lingering doubts on its interpretation and allow our country to continue to be attractive also in the eyes of foreign investors and those professionals specialised in acquisitions of minority interests.

As mentioned earlier, one of the positions expressed by the Italian Tax Authority in Circular Letter No. 6/2016, which has been the subject of criticism by legal scholars, concerns the topic of VAT deduction of the transaction costs incurred by the cited investment vehicles for the purpose of acquiring the target company. In this regard, the Italian Tax Authority, citing the guidelines of the European Court of Justice on the issue of holding shareholdings ([1]), argued that: "*the mere acquisition of company holdings, without carrying out further transactions and subject to VAT, does not form the performance of an economic activity, by virtue of which a company may acquire the status of taxable person* (i.e. static holdings - Ed.). *The right to tax deduction is thus precluded, linked inseparably to qualifying the professional as a taxable person. Such recognition, in fact, is contingent on the "intrusion" or "interference" in managing those subsidiaries, which results in completing transactions falling within the scope of the tax's application, such as the provision of administrative, financial, business and technical services to subsidiaries* (i.e. dynamic holdings - Ed.). *In consideration of the above, therefore, where in the presence of a situation where the vehicle company's task is to merely hold shares, without interfering in any way in the subsidiaries' management, in our opinion neither the abovementioned vehicle company or - after the merger - the target company are entitled to deduct the VAT charged on other fees where the same has been incorporated or has incorporated the cited SPV*".

[1] Settled case-law of the Court establishes that the interference of a holding company in managing companies in which it has shareholdings, constitutes an economic activity under Article 9, paragraph 1, of the VAT Directive, where it entails carrying out transactions subject to VAT under Article 2 of that Directive, such as the provision of administrative, accounting, financial, business, computer and technical services by the holding company to its subsidiaries.

It is clear from the above how, according to the Italian Tax Authority's view, Bidcos are companies that are comparable to “holding” companies and cannot, on the contrary, be classified as companies that are instrumental to completing the LBO transaction or companies that conduct preparatory activities in the pursuit of the target's business activity, which is realised through the subsequent merger of the Bidco and the target (such a merger, however, already envisaged and regulated in all documents accompanying the acquisition and its financing). This approach of the Italian Tax Authority has meant that most professionals in the industry consider that the VAT related to transaction costs incurred by Bidcos in LBO transactions are not deductible.

That topic has become newsworthy in 2018 in light of some important positions expressed at the European Community level both in terms of judgments as well as in terms of conclusions of the Advocate General. These latter, where confirmed, could be interesting points to consider when rethinking the VAT scheme to apply to the abovementioned types of costs incurred by Bidcos. We specifically refer to the opinion of the Advocate General delivered on 3 May 2018 in relation to Case C-249/17 (Ryanair Case), to the judgment of the European Court of Justice of 5 July 2018 in relation to Case C-320/17 (Marle Participations Case) and the opinion of the Advocate-General delivered on 6 September 2018 in relation to Case C-502/17 (C&D Food Case), briefly summarised below.

Case C-249/17 (Ryanair Case) - opinion of Advocate General Juliane Kokott delivered on 3 April 2018

The dispute (better known as the Ryanair Case) concerns the deductibility of VAT paid on costs incurred by an industrial company (thus not a holding or a Bidco) to purchase the stake in a competitor, in the particular case of the unsuccessful execution of the acquisition. In such a scenario, the possibility for the buyer to provide services that constitute, on the basis of established European Community case law, an indication of the involvement necessary to support the deductibility of VAT paid on the costs incurred to execute the acquisition would not exist.

More specifically, the case in question concerns Ryanair's attempted takeover of Aer Lingus, an Irish competitor, which failed for reasons of competition law. Regardless of the outcome of the transaction, Ryanair claimed, contrary to the positions of the Irish tax authority, full deductibility of the VAT paid on consultancy costs incurred in the context of that transaction.

The line of reasoning developed by the Advocate-General Kokott make it clear that, unlike holding companies, where the acquisition is promoted by an industrial company, the analysis of the deductibility of consulting expenses incurred to purchase shares must disregard the analysis between the costs incurred in connection with the purchase of the shares and the management services envisaged.

More specifically, in her line of reasoning, the Advocate-General states that, "*according to the Court’s case-law, direct involvement in management by supplying management services is certainly not the only case where the holding of a share can constitute an economic activity. Rather, the Court considers an economic activity to exist whenever the acquisition or holding of the share has a typical business character. This is the case, for example, with commercial securities trading or if the acquisition or holding of shares constitutes a direct, permanent and necessary extension of a taxable activity*".

It is within this meaning that the strategic acquisition of a competitor should be framed considering that "*the acquiring company pursues the aim of extending or modifying its operating business. Although such a takeover is accompanied by the acquisition of shares in the company, it constitutes a measure aimed at (extended) taxable turnover*". **The innovative view of this line of reasoning lies in the principle that "*the question of the link between the costs incurred in connection with the acquisition of shares and the intended management services thus no longer arises*" for the subsidiary. The present case points out, rather, "*the link between the acquisition of shares and the (intended) turnover from the operating airline business*".**

Furthermore, the fact that the intended acquisition and the continuation of the business did not, in fact, take place, "*has no bearing on this conclusion. Here too,* ***the intention*** *of engaging in economic activity,* *proven by objective factors,* ***is sufficient****. That intention cannot be called into question subsequently on the ground that there was in fact no takeover (...)".*

In her opinion, Advocate General Kokott clarified that the acquisition of all the shares in a company, with the intent to directly and permanently expand in this way the taxable business of the acquiring company (i.e. "strategic acquisition"), constitutes an economic activity, and therefore the costs incurred in the context of such a strategic acquisition have a direct and immediate link with its taxable activity, making the VAT paid on those expenses fully deductible. This principle must above all first free the field from any issues on interpretation raised by certain professionals in relation to the right to deduct VAT incurred by the target company in the case of acquisitions of other shareholdings in competitors (i.e. *"*add-on*").*

Furthermore, if the opinion put forward by the Advocate General is also reflected in the final judgment (as seems desirable in light of the principles laid down by Judgment C-320/17 analysed below), in our opinion the details to argue that such an approach could be extended also to Bidcos established with the intent to pursue and expand the target's business activities, in which they will be subsequently merged, do exist. This is because in all contractual documents that characterise the acquisition ([2]), the Bidco's function is well evident, which is not that of a mere holding company, but rather to establish the vehicle intended to be merged (often with strict deadlines) with the target and to exercise the economic activity thereof, and this apart from the fact that the Bidco had initially indicated (or did not indicate) their intent to provide the target with management services in the merger's interim period.

<u>Case C-320/17 (Marle Participations Case) – Judgment of the Court of Justice of the European Union of 5 July 2018</u>

The topic of the right to deduct VAT on the purchase of shareholdings was recently addressed by the same Court of Justice of the European Union in its judgment in Case C-320/17 (Marle Participations Case). The dispute in question concerns the case of Marle Participations, a holding company of the Marle Group, that had deducted the VAT incurred on the purchase of certain shareholding insofar as it carried out the economic activity in respect of the subsidiaries, consisting in leasing properties.

In the case in question, the Court of Justice of the European Union, after citing the principles previously expressed on the subject of VAT deduction for static and dynamic holdings ([3]), also made it clear that "*the letting of a building by a holding company to its subsidiary constitutes involvement in the management of that subsidiary which must be considered to be an economic activity* [...] *giving rise to the right to deduct the VAT on the expenditure incurred by the company for the purpose of acquiring shares in that subsidiary* [...]".

It is worthwhile pointing out that the abovementioned right to the VAT deduction does not simply apply in all cases, but rather it is limited to all cases in which the provision of services in question are constant, are conducted for a consideration and are subject to VAT. Consequently all cases where lease agreements (and more generally, service agreements) are subject to a VAT exemption scheme are excluded.

The judgment is relevant in that the Court of Justice of the European Union extended an established principle of European Community case law to include leases in the concept of "interference" of the holding company in the choices of the subsidiary. That ruling has made it clear that the existence of such an arrangement between the holding company and a subsidiary constitutes interference in the management of the latter, thus qualified as an economic activity under Article 9 of Council Directive No. 2006/112/EC, consequently bringing about the right to deduct the VAT paid on expenses incurred by the company to purchase the shares in that subsidiary.

The principles expressed in the judgment in question – although it is of little importance for typical LBO transactions carried out by investment funds, because Bidcos are never endowed with properties covered

[2]Consider, for example, the investment agreement and the loan agreement, which always give clear evidence of the role of the "vehicle" carried out by Bidco and its merger into the target immediately after executing the acquisition.

[3] See Footnote 1.

by leases – it is however contributory for all those international or family industrial groups, in which the holding company also holds the group's immovable property, which is then leased to their portfolio companies. These are typical structures especially in family industrial groups in which the group's immovable property is often split inside the holding company, also to limit their business risks.

In addition to the interesting idea offered in connection with the principle of interference, in our opinion, that judgment may also affect the outcome of Judgment C/249-17 by confirming the opinion of the Advocate General.

Case C-502/17 (C&D Foods Case) – Opinion of Advocate General Kokott delivered on 6 September 2018

As mentioned above, in recent years the Court has examined in several cases the right of a holding company to enforce the deduction of the input VAT paid in the context of purchasing company shares. In that scenario, the opinion delivered by the Advocate General in the context of Case C-502/17 becomes relevant in that it concerns the speculated case of the sale of shares by a holding company. The case under consideration therefore offers the Court an opportunity to clarify its position with regard to the right of holding companies to deduct VAT for costs incurred to execute the disposal of a subsidiary's shares.

The dispute (better known as the C&D Foods Case) concerns the deductibility of VAT paid for consulting services received in the context of the intended, but not completed, sale of its subsidiary (Arovit Petfood) to which the holding company provided consulting services subject to VAT. The case, though diametrically opposed to previous cases analysed by the Court, represents an important step in understanding the VAT scheme as it relates to all costs that usually, even in the private equity market, are incurred in the exit stage (i.e. vendor due diligence costs and costs for legal tasks associated with the SPA's negotiation).

Advocate General Kokott in developing her line of reasoning provides interesting insights in which to frame the correct treatment for VAT.

On one side it is clarified that "*according to case law, the end and the start of an economic activity must be treated in an identical manner, in accordance with the principle of fiscal neutrality*. ***In the same way that the purchase of shares may constitute, under certain conditions, a preparatory act to an economic activity, which falls within the scope of the application of VAT, this must also apply to the sale of shares, which puts an end to an economic activity".*** Therefore, a holding company's sale of the shareholding in a subsidiary can be considered an economic activity and abstractly capable of implying the VAT deductibility of costs incurred during the exit stage.

On the other, an established principle of the Court is reaffirmed, according to which it is necessary to consider whether the consulting services received by the holding company have a direct and immediate link with the sale of the shares (an exempt transaction). In that case, indeed, the deductibility of VAT paid in relation to these services would be precluded in full. In the case of Advocate General Kokott, this link seems to be clearly established in that the consulting service focused precisely on the draft of an agreement for the sale of shares. However, for the purposes of the abovementioned verification, and therefore the deductibility of VAT, the fact that the sale was ultimately not executed is irrelevant (cf. paragraph 47).

Pending the judgment, Advocate General Kokott argued in her opinion that, although the sale of the shares of an indirect subsidiary, with which a taxable activity previously carried out ends, constitutes an economic activity abstractly capable of sustaining the deductibility of VAT, where there is a direct and immediate link of the consulting services received with the sale of shares (exempt transaction under Article 135, paragraph 1, letter f) of Directive 2006/112), the tax deduction is not due.

In light of the foregoing, it would also establish the scope of the costs for which there is a direct and immediate link with the sale (e.g. drafting an agreement for the sale of shares and the associated guarantees) and which ones might not have a direct and immediate link with a specific sale (e.g. due diligence reports or business analysis drafted not for a specific and programmed sale but at the outset, to evaluate any disinvestment opportunity).