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An Insight Into The Private Equity Sector

1 Private Equity Market Overview

1.1 Trends and outlook of the market: the level of private equity activity in recent years and developments in 2017

The periodic survey conducted by the Italian Association of Private Equity (AIFI) and PricewaterhouseCoopers Transaction Services shows that, in 2017, the investment activity in the Italian private equity and venture capital market continued its positive trend of 2016 and 2015. The figures for 2017 highlight the following data:

- a total of 311 transactions carried-out for an overall value of EUR 4.938 million, of which 74 involving international operators and 126 domestic operators, corresponding to an increase on the sourcing side by domestic operators in comparison to 2016 (+ 195%) and 2015 (+ 79%);
- most of the investments were performed in the early-stage segment (133 transactions for an overall value of EUR 133 million), followed by buyouts and expansions (90 and 45 transactions corresponding to an overall value of EUR 3.444 million and EUR 338 million, respectively);
- investments are mostly located in northern Italy (72% on a total of 92% Italian transactions) where, on a regional level, Lombardy is still playing a leading role (114 transactions, corresponding to 40% of the capital transactions).

1.2 The current major players

In 2017, the overall economic resources collected by operators located in Italy amounted to EUR 5.063 million, of which EUR 4.110 million from institutional investors and EUR 920 million from private investors. These figures do not include the resources deriving from pan-European funds based in Italy: in such case, the total capital collected would amount to EUR 6.138 million (+76% than in the previous year).

Most of the transactions (63%) were carried out by international operators, such as pan-European funds, followed by private investors (23%) and institutional investors (13%), such as asset managers and country funds.

1.3 The principal sources of funding for private equity

The main sources of 2017 funding raised from:

- Individual investors: 27% (21.2% in 2016);
- Funds of private funds: 17.5% (23.2% in 2016);
- Public institutions: 13.7% (2.3% in 2016);
- Banks: 12.1% (7.1% in 2016);

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- Pension funds: 10.6% (12.3% in 2016);
- Banking foundations: 7.1% (2.8% in 2016).

2 Tax Environment

2.1 General principles of the tax system

The Italian Tax Law is governed by Decree No. 917 issued on 22 December 1986 by the President of the Republic (*Testo Unico delle Imposte sui Redditi*, hereinafter also "TUIR"), which sets forth the statutory framework of corporate income tax (*Imposta sul Reddito delle Società*, hereinafter also "IRES") applicable to resident and non-resident companies in Italy. In addition, the Italian tax system provides for the Regional Tax on Productive Activities (*Imposta Regionale sulle Attività Produttive*, hereinafter also "IRAP"), which tax rate can vary from region to region.

A company is considered resident for tax purposes in Italy, and thus subject to tax on its worldwide income, if it has: (i) its registered office (or legal seat), (ii) its place of effective management, or (iii) its main business in Italy for the greater part of the year. According to a domestic anti-avoidance rule, a foreign company is deemed to be resident in Italy for tax purposes if it holds a substantial interest in an Italian company and, in turn, either it is controlled by another Italian company, or most of its Board of Directors is composed by Italian residents.

The main types of legal entities liable to IRES in Italy are: Joint Stock Companies (SPA – *Società per azioni*), Limited Liability Companies (SRL – *Società a responsabilità limitata*) and Partnerships Limited by Shares (SAPA – *Società in accomandita per azioni*).

2.2 Recent tax reforms or tax proposals which may affect the private equity market

Primarily, a new tax regime applicable to carried interest proceeds has been introduced by Law Decree no. 50 of 24 April 2017 (*see* section 7.2.3.1).

An important tax reform that may largely impact the private equity market is the one dealing with the Registration Tax (*Imposta di Registro*), where the Italian legislator clarified that the subjective scope of such taxation should be strictly found in the nature of each single deed. In fact, the previous law gave rise to too many interpretative issues connected with the treatment applicable to deeds subject to Registration Tax.

Lastly, Italy implemented a new definition of permanent establishment in line with the OECD Transfer Pricing Guidelines 2017 and BEPS Action 7. Under the new provision, a non-resident entity is deemed to constitute a permanent establishment in Italy if it has "a significant and continuous economic presence" in the territory.

2.3 Corporate income tax

<u>2.3.1 Taxation of resident companies</u>

Businesses are subject to IRES and IRAP. The former is calculated by making upward or downward adjustments to the profits shown in the statutory accounts for the relevant fiscal year, in accordance with the rules established by the TUIR and subjecting it to the standard IRES rate (currently at 24%, with a surtax equal to 3.5% for banks and financial institutions). A resident company may also opt for the Branch Exemption Regime (under the clause "all-in, all-out"), which means that profits and losses deriving from foreign permanent establishments are excluded from the taxable base in Italy, as alternative to ordinary taxation with tax credits.

For IRAP purposes, the taxable base is calculated on the net value of production generated in each tax period by entities engaged in business activities with the exception of certain items of labor costs and losses on receivables. Financial items are therefore not taken into consideration for IRAP purposes. The average IRAP tax rate is 3.9%, while Italian regions maintain the directionality to increase (or decrease) the relevant tax rate up to 1%. Specific provisions are also applicable to banks and financial institutions.

Under Italian tax law, a tax consolidation regime (for IRES purposes only) is available. The election can be made by domestic entities and, to a certain extent, non-resident companies (if located in a country with which Italy has into force double tax treaty which provides for an adequate exchange of information and the non-resident carries-on in Italy a business through a permanent establishment located therein). It applies for at least three years and is deemed to be renewed.

2.3.2 Taxation of non-resident companies

Non-resident entities are subject to IRES deriving from sources of income located in Italy. In case of business income derived from permanent establishments of foreign companies, IRES is calculated in the same way as per resident companies (*see* section 2.3.1), otherwise it is computed in accordance with specific provisions for each item of income (*i.e.* income and gains from real estate assets situated in Italy, royalties, interests, miscellaneous income or activities carried out in Italy). Non-resident entities are subject to IRAP, if they maintain a permanent establishment in Italy for at least 3 months or, in case of partnerships and individuals, they carry on an autonomously organized business in Italy. The tax rules for IRAP calculation are the same applicable to resident companies (*see* section 2.3.1).

2.4 Participation Exemption

2.4.1 Dividends

Dividends derived by resident companies are excluded from the corporate income tax base up to 95% of their amount. Thus, only 5% of dividends is included in the relevant IRES taxable base (effective tax rate at 1.2%). Nonetheless, if the subsidiary is resident in a black-list jurisdiction (as defined under Italian controlled foreign company rule) dividends are wholly relevant for IRES purposes, unless taxpayers can prove to the tax authorities (through an appropriate tax ruling) that the foreign subsidiary is not used to shift profits and benefit of most favorable tax regimes. In contrast, dividends are generally excluded from IRAP taxable base.

2.4.2 Capital gains from share disposal

A specific participation exemption regime (*Pex)* is also applicable for capital gains deriving from the disposal of shareholdings, resulting in a partial exemption (95%) from IRES taxable base deriving from the sale of shares. The provision is applicable if: (i) the participation is held continuously for the last 12 months prior the sale, (ii) the participation has been booked as financial fixed assets in the financial statement since its initial acquisition, (iii) the foreign company has never been resident in a jurisdiction that is deemed to have a low-tax regime under for the purposes of the Italian rule on foreign subsidiaries and (iv) the subsidiary carries on an actual business activity. The third and fourth conditions must be met at least from the third year preceding the date of the sale of the investment. As a general rule, capital gains that do not qualify under PEX regime can be taxed in five fiscal periods: the year of realization and the subsequent 4 years.

In contrast, capital gains on financial investments are generally excluded from IRAP taxable base.

2.5 Interest deduction

Italian Tax Law provides that the deduction of interest resulting from the companies' financial statements and referred to any transaction having a financial purpose (*e.g.* interest from loans, bonds issued, notional cash pooling or finance leasing agreements), is subject to the following rules. Firstly, interest expenses are fully deductible up to the amount of interest income. Secondly, any excess of interest expenses is deductible up to 30% of the EBITDA or gross operating margin ("*reddito operativo lordo*", also "ROL"). EBITDA is calculated as the difference between the value of production (item A of the profit and loss scheme, contained in article 2425 of the Civil Code) and the costs of the production (item B) grossed up by depreciations, amortizations and financial leasing. However, if in any fiscal year the net interest expenses are higher than 30% of the EBITDA, the difference may be carried forward without time limitation for offsetting against available ROL. Also, if 30% of the EBITDA exceeds the net interest expenses in any fiscal year, the difference may be carried forward to increase the deductible limit. Special rules apply in case of tax group consolidation, where any excess of net interest expenses (or 30% of the EBITDA) may be transferred to the companies belonging to the group, and used for that member's deductibility of net interest expenses purposes.

2.6 Loss carry-forward

For IRES purposes only, tax losses realized in a fiscal period can be carried forward without any time limitation to offset 80% of the taxable income in subsequent years. Tax losses incurred in the first three years of business activity can be carried forward and used to offset taxable income without the aforementioned threshold (80%). Tax losses cannot be carried back.

2.7 Withholding taxes

2.7.1 Dividends

Generally, dividends paid by resident companies to other resident companies are not subject to withholding tax. Instead, a final withholding tax of 26% applies to dividends paid to non-resident companies without a permanent establishment in Italy. Nonetheless, non-resident recipients are authorized to claim a partial refund of the tax paid in Italy (up to 11/26 of the Italian withholding tax) whether they can demonstrate to the Italian tax authorities that a final tax on the same dividends has been already paid in their country of residence (reducing therefore the effective tax rate to 15%).

In principle, in case of dividend payments made by Italian companies to non-residents, the percentage of the withholding tax may be reduced by double tax conventions. Italy's double tax treaties network generally follows the OECD Model Convention that provides for the limitation of the source state's right. The withholding tax is also reduced to 1.2% if the recipient is resident in an EEA country that allows for adequate exchange of information with Italy, and qualifies as the beneficial owner of the income. However, under the domestic law implementing the EU Parent Subsidiary Directive, the tax rate on outbound dividends amounts to zero.

2.7.2 Interest

As a general rule, interest paid by resident companies to non-residents are subject to a final withholding tax of 26%, unless the recipient has an Italian permanent establishment. Italy's right to tax is also restricted by tax treaties to a certain percentage if the recipient of the income qualifies as the beneficial ownership. Under the domestic law implementing the EU Interest Royalties Directive, interest payments are exempt from taxation at source.

2.8 General and Special Anti-Avoidance Rules applicable to Private Equity structures

Italy's legislator has recently strengthened the set of instruments aimed at preventing the erosion of resident companies' taxable base. A statutory general anti-avoidance rule (GAAR) has been codified into Law No. 212/2000, addressing both the anti-avoidance rule and the abuse of law principle. In a nutshell, under the Italian GAAR the assessment of an abusive behavior can be conducted by tax authorities if taxpayers carry out "one or more transactions lacking of any economic substance which, while being formally compliant with the tax rules, they essentially achieve an undue tax advantage". A transaction is therefore deemed to be challenged whether it lacks of any economic substance (*e.g.* it involves facts, deeds and contracts that are in conflict with the purpose of the relevant tax provisions and the principles of the tax system) or it is mainly put in place to achieve a tax advantage that, in the absence of the transaction carried-out, would not have been obtained. In terms of SAARs, Italian tax law comprises a number of regulations. A non-exhaustive list may include: the controlled foreign companies' legislation, the provision to limit the deduction of interest expenses (*see* section 2.5) as well as the mechanism of tax losses carry-forward to offset taxable base (*see* section 2.6) or tax losses carry-forward in merger and demerger situations.

The Italian CFC legislation has been revised several times over the last years. Under the latest version, a country is presumed to be black-listed for tax purposes if its nominal tax rate is lower than 50% of the combined IRES and IRAP rates. In such a case, the profits of the non-resident subsidiary are allocated to the Italian resident shareholder in proportion to its equity interest. In contrast, entities residing in another Member State or EEA country that allows for an adequate exchange of information with Italy, are not subject to the "nominal tax rate" test. Nevertheless, they must meet other conditions to avoid the application of the CFC legislation (*i.e.* in terms of effective taxation and percentage of passive income accrued).

With reference to the provision limiting the carry-forward of tax losses in case of mergers and demergers, it establishes that the carry-forward is only possible under certain conditions whereby the company's profit and loss account, for the tax year preceding the one in which the merger or demerger took place, shows revenues from business and employment costs higher than 40% of the previous 2 years average.

3 Regulatory Overview for Investment Funds and Principal Regulatory Bodies

The principal regulations concerning UCI are:

- Legislative Decree no. 58/1998 (the "Consolidated Financial Act" or "TUF");
- Ministerial Decree no. 30 of 5 March 2015 which sets out the main criteria with which investment funds should comply (the "Decree");
- Bank of Italy's Regulation of 19 January 2015, as amended by the decision of 23 December 2016, the regulation on collective asset management (the "Asset Management Regulation");
- CONSOB (as defined below) Regulation on Issuers (CONSOB regulation no. 11971/1999);
- CONSOB Regulation on Intermediaries (CONSOB regulation no. 20307/2018).
- The main Italian regulatory bodies are: CONSOB (the Italian Securities and Exchange Commission) and the Bank of Italy.

4 Major Investment Fund Types: Forms of Vehicles and Legal Structures

The fundamental definitions contained in the TUF and referring to UCI are:

- "collective asset management": "*the service which is carried out through the management of UCIs and of the relative risks*" (Article 1 (1)(n) of the TUF);
- "UCI" (Undertaking for Collective Investment): "*body set up to provide the service of the collective management of assets, the capital of which is obtained from multiple investors by the issue and offer of units or shares, managed upstream in the investors' interests and independently by the same and also invested in financial instruments, credit, including credit backed, in favour of subjects other than consumers, by the UCITS capital, equity or other fixed or non-fixed assets, on the basis of a predetermined investment policy*" (Article 1(1)(k) of the TUF);
- "variable capital investment company" (SICAV): "*open-end UCIs established in the form of a joint-stock company with variable capital with registered office and general management in Italy for the exclusive purpose of providing for the collective investment of the assets obtained through the offer of its own shares*" (Article 1 (1)(i) of the TUF);
- "fixed capital investment company" (SICAF): "*closed-end UCI set up in the form of a joint-stock company with fixed capital, registered office and general management in Italy for the exclusive purpose of providing for the collective investment of the assets obtained through the offer of its own shares and other financial instruments of equity held by the same*" (Article 1 (1)(i-bis) of the TUF);
- "investment fund": "*UCI established in the form of an enterprise with independent equity, divided into units, set up and managed by a fund manager*" (Article 1(1)(j) of the TUF).

In the Italian market, the most common type of UCI is the investment fund, therefore the present paper will focus on the mentioned UCI. Regarding investment funds, it is worth mentioning that, according to a recent and innovative decision of the Milan Court (N. 7232/2016), the investment fund should be considered as an entity endowed with legal personality. Moreover, the investment fund is managed by an asset management company (*Società di Gestione del Risparmio*, "SGR", according to Article 36 (1) of the TUF), which must be authorized to operate by the Bank of Italy, after consultation with Consob, and be registered in a special list held by the Bank of Italy (Article 35 (1) of the TUF). The investment fund's assets shall be deposited with a custodian (either an Italian bank, the Italian branch of an EU bank or a bank based in non-EU countries, an investment firm or an Italian branch of an EU Investment company or a company based in non-EU countries, other than banks – "Custodian") whose duties are provided by Article 48 of the TUF.

The main types of UCI (the focus is on fund) are:

Open-end UCIs

The main characteristics of this type of fund are the possibilities for the investors to enter and exit into/from the fund almost without limitations. Precisely, the investors can subscribe the fund's units in every moment and the unitholders can request the redemption of the units, according to the relevant provision of the fund's regulation, in every moment. The Asset Management Regulation, Title V, Chapter III, Section III, paragraph 22 provides for the permitted composition of the portfolio of this type of funds. The Italian legislation included the SICAVs in the category of open-end UCIs.

Closed-end UCIs

The main characteristics of this type of fund are: (i) the subscription of the fund's units can be performed only in determinate period and quantity; (ii) the redemption of the units can be requested only upon termination of the fund (the fund duration cannot exceed 50 years). The Asset Management Regulation, Title V, Chapter III, Section III, paragraphs 25 to 28 provides for the permitted composition of the portfolio of this type of fund. The Italian legislation also included the SICAFs in the category of open-end UCI.

Reserved UCIs

The participation to a Reserved UCI is limited to professional investors as defined in Article 1 (1)(p) of the Decree which refers to Articles 6 (2-*quinquies*) and (2-*sexies*) of the TUF.

5 Fund structuring

5.1 Fund manager and fund administration

5.1.1 Role

The investment fund management is performed by an asset management company (SGR), which will manage the investment fund and invest its resources in accordance with the investment fund's regulation.

5.1.2 Requirement imposed

In order to be authorized by the Bank of Italy, after consultation with Consob, the SGR must fulfil the requirements established by Article 34 (1) of the TUF and listed below:

- the legal form adopted is that of a joint-stock company;
- the registered office and the head office of the company are situated in Italy;
- the paid-up capital is not lower than that established on a general basis by the Bank of Italy. The minimum corporate capital requirement for an SGR is EUR 1 million (title II, chapter I, section II.1 of the Asset Management Regulation). Such amount is reduced to EUR 500.000 for SGRs managing closed-end reserved alternative investment funds (title II, chapter I, section II.1 of the

Asset Management Regulation), and to EUR 50.000 for SGRs falling below certain thresholds set out under title II, chapter I, section VII of the Asset Management Regulation;

- the persons in charge of the administrative, management and control functions are suitable under Article 13 of the TUF;
- the shareholders indicated in article 15, paragraph 1 of the TUF, have the requirements and meet the criteria laid down by Article 14 of the TUF and the disqualification conditions contemplated by Article 15, paragraph 2, of the TUF did not occur;
- the structure of the group of which the company is part is not prejudicial to the effective supervision of the company and at least the information required under Article 15(5) of the TUF has been provided;
- a programme of initial operations and a description of the organizational structure have been submitted together with the instrument of incorporation and the Articles of Association; and
- the name of the company contains the wording "asset management company".

The authorization shall be denied if sound and prudent management is not ensured.

5.1.3 Activities carried out

The SGR shall perform collective asset management services for UIC and other activities (*i.e.* incorporation and management of pension funds; portfolio management *etc.*).

Regarding investment funds, the SGR incorporates the fund and approves the fund's regulation which "defines the features of the fund, governs the functioning of the same, identifies the manager and the custodian, defines the allocation of tasks between such subjects, and regulates the relationships between such subjects and the fund investors". The mentioned regulation constitutes the fundamental document of the investment fund and it establishes the relation among the fund and the investors, the Custodian, and the SGR; the regulation shall be approved by the Bank of Italy unless the investment fund is a reserved fund. Moreover, the SGR will manage the UIC and invest the resources provided by the investors in the goods indicated in the fund's regulation.

5.1.4 Regulatory framework

In order to be authorized to collective asset management, the SGR shall make the relevant request to the Bank of Italy and present the activity programme and the organizational structure of the SGR.

According to the TUF and the Asset Management Regulation, the corporate officer of the SGR must satisfy the requirement of professionality, honorableness and independence set out in Article 13 of the TUF.

The mentioned legislation also required the SGR's shareholders to satisfy the requirements of honorableness, competence and fairness in order to ensure the sound and prudent management of the SGR (Articles 14 and 15 of the TUF).

6 Leveraged Buy-Out and Re-Leveraged Buy-Out: Opportunities and Limits

6.1 Opportunities

Following the corporate law reform, which was enacted in 2004, leveraged buy-out transactions ("LBO") are allowed under the Italian Civil Code (the "Code") as long as the general rules on financial assistance, contained in Articles 2357, 2358 and 2474 of the Code are not breached.

Moreover, the Italian legislator provided specific rules concerning merger leveraged buy-outs ("MLBO") which relate to the merger of two companies, one of which incurred debt for the purchase of the other, whereby because of the merger, the assets of the target become a generic security for the reimbursement of the debt. Under Article 2501-bis of the Code, such a transaction is legitimate only if carried out in compliance with specific formal and substantive requirements.

Likewise, private equity funds, by leveraging the company with new debt, usually resort to re-leverage buy-out transactions with the purpose of cashing out the equity invested in the target company. The transaction is carried out by selling the shares of the target to a Newco, incorporated by the same fund (sometimes with another minority shareholder), and which uses leverage to finance the buy-out. Re-leverage transactions may give rise to issues relating to the financial assistance veto and to the inadmissible deductibility of financial interests when tax authorities consider the operation as invalid due to the lack of sound economic reasons. Hence, re-leverage transactions must be structured and carried out carefully and appropriately in order to comply with the law.

6.2 Limits

As already mentioned, LBO and MLBO transactions are limited by the rules concerning financial assistance. In particular, if the target company is a joint-stock company, it is not allowed to grant loans or to provide guarantees for the purchase or subscription of its own shares without complying with some conditions provided for in Articles 2357 and 2358 of the Code, such as, *inter alia*:

- prior authorization of the transaction granted by the extraordinary shareholders' meeting;
- at least 30 days preceding the shareholder's meeting, the directors deposit at the registered office of the company a report on the transaction specifying:
  - the transaction's terms and conditions;
  - the economic objectives and the specific interests pursued through the transaction;
  - the risks associated with the company's solvency and liquidity;
  - the shares subscription and purchase price; and
  - whether the transaction will be carried out at arm's length;
- the shareholders' meeting minutes, the shareholders' resolution and the report are filed in the Companies' Register within 30 days, and
- the aggregate amount of the loans and guarantees does not exceed the distributable dividends and the available reserves resulting from the company's last financial statements.

Moreover, due to Legislative Decree no. 139/2015, which amended Article 2357-*ter* of the Code, the purchase of own shares is deemed as a reduction in the value of equity. Therefore, a special purpose non-distributable reserve is required to be entered in the company's financial statements for an amount equal to the price paid.

7 Economic Flows to Private Equity Transactions

7.1 Transaction costs

7.1.1 Transaction costs for acquisition of businesses: accounting and tax treatment

Transaction costs' accounting and tax treatment generally depend on the accounting principles chosen by the company. Under Italian GAAPs, costs directly incurred to acquire an interest should be capitalized over the purchase price of the target shares (*e.g.* legal, tax, accounting, operational and environmental due diligence, investment banking and finder fees and other costs directly linked to the investment, *etc.*). Conversely, other residual transaction costs not directly attributable to the acquisition should be booked into the profit and loss accounts. Moreover, Italian GAAPs do not provide for a specific list of costs directly attributable to the transaction. Indeed, a case-by-case analysis is generally required. In the event of costs that may refer to both the acquisition and the related financing (such as financial due diligence or other legal and advisory fees), it is a common standard to allocate the incurred costs to the value of the investment based on specific allocation keys (*e.g.* investment company or vehicle debt/equity ratio). From a direct tax point of view, costs capitalized over the purchase price of the target shares are not deductible, not even after a merger. Other residual costs directly recorded in the profit and loss accounts could generally be considered as deductible costs. Rather, under IAS/IFRS GAAPs the capitalization of transaction costs is not allowed and therefore they must be directly allocated to the profit and loss accounts. As for the deduction from IRES and IRAP taxable basis, the transaction costs directly attributable to the acquisition are fully deductible. As for the input VAT, either in case of Italian or IAS/IFRS GAAPs, the deduction is linked to the activity carried out by the company bearing the transaction costs. Should the acquiring company be a holding company not carrying out any economic activity, the VAT related to those transaction costs would be considered as non-deductible. Otherwise, the input VAT incurred on such costs would be generally deductible. On top of that, regardless of the accounting principles, the deduction of the transaction costs for direct tax purposes depends on the general inherence principle provided by Italian tax law. Based on such principle and broadly speaking, a cost is deductible to the extent that it is related to the company's business activity (*e.g.* when it is borne in the main interest of the company for providing a direct or even an indirect benefit to the company's business). In this respect, if the target company accrues the transaction costs, the latter should be considered as non-deductible since incurred for the company's shareholders benefit.

7.1.2 Transaction costs analysis for sellers: characterization of the earn-out payment and timing of gain recognition

Earn-out payments should be recorded by the seller in the profit and loss accounts as an increase or decrease of the original capital gain/loss. As for IRES purposes, should the participation exemption regime be applicable (*see* section 2.4.2), the payment received by the seller would be exempted for 95% and the cash-out would be fully non-deductible. Conversely, should the Pex regime be non-applicable, each higher or lower capital gain/loss would be fully taxable or deductible, respectively. Earn-out payments are excluded from IRAP taxable basis and are VAT-exempt. As for the timing of the gain/loss, Italian corporate entities should tax or deduct the earn-out payment in the fiscal year in which it is accrued in the profit and loss accounts (*e.g.* when the underlying agreement would be considered certain and final, which typically corresponds at the payment date).

7.1.3 Transaction costs for financing issues. Accounting and tax treatment for and legal fees: legal and advisory fees

Under both Italian and IAS/IFRS GAAPs, transaction costs incurred on borrowings and other financial liabilities (including legal and advisory fees) are amortized over the term to maturity of the related liability (using the "amortized cost method"). More in detail, such transaction costs should be included within the initial carrying value of the financial liability, thus reducing it. Consequently, it leads to the determination of an effective interest rate which is higher than the nominal one. As a result, the cost of the advisors would be converted into interest expenses during the financial liability lifetime. From a tax standpoint, since the transaction costs related to the financial liabilities increase the amount of interest expenses, the deduction of such a higher value must be evaluated under the ordinary provision set forth by Italian tax law, *i.e.* on the basis of the available EBITDA amount (*see* section 2.5). Conversely, such costs are not deductible from the IRAP taxable basis.

7.1.4 Recurring Management Fees. Accounting and tax treatment

Fees charged by the management company to the fund are not tax-relevant, since the fund is generally not subject to corporate tax. Should such fees be re-charged to the Target, the comments below will apply.

Recurring fees charged to the Target (*e.g.* a portfolio company) for ongoing advisory and management services after the acquisition are generally included in the profit and loss accounts based on the standard accrual principle. The Italian law does not provide for any specific tax rule. The deduction of such expenses by the portfolio company depends on the general "inherence principle". A case-by-case analysis is indeed required. In this respect, a cost is deductible if it is borne in the main interests of the company for providing a direct, or even an indirect, benefit to the company's business; and not in the interests of the fund or the management company itself. More in detail, the tax deduction of each cost incurred should be supported by an adequate set of documentation aimed at proving that: (i) the services have been effectively provided, (ii) the underlying activities are performed on behalf of the subject for which the services are provided and (iii) the price charged is proportional to the services rendered. The burden of proof concerning the simultaneous existence of all the above-mentioned requirements lies upon the subject deducting the costs for tax purposes. Moreover, should the entity charging the fees be a foreign taxpayer, the ordinary transfer pricing rules apply.

7.1.5 Interest deduction from financing: tax treatment and withholding taxes

Interest expenses from financing are tax deductible for IRES purposes up to the amount of interest income and, thereafter, up to 30% of EBITDA (*see* section 2.5). Interest expenses are not deductible for IRAP purposes. Should the liability be subscribed or transferred or assigned to foreign lenders (without a permanent establishment in Italy), interest paid to these entities could trigger a 26% withholding tax, or the reduced tax provided by a double tax treaty or by the Interest-Royalties Directive, if all the relevant conditions are met. Notwithstanding, in order to broaden access to credit for Italian enterprises, the Italian tax law provides for a further withholding tax exemption for eligible foreign lenders. More in detail, provided that specific regulatory provisions on reserved lending activity are met, no withholding tax applies on interest payments made under medium/long-term facilities granted to Italian businesses by: (i) banking entities established within the EU, (ii) insurance entities established and authorized under the laws of a EU Member State, (iii) certain selected European credit entities, or (iv) institutional investors established in a jurisdiction (both EU and non-EU) allowing for an adequate exchange of information with the Italian tax administration and subject to supervision in their home jurisdiction.

7.2 Taxation of investment funds

Investment funds can be divided into two different groups: (i) investment funds other than real estate funds, when the unitholders' capital is not mainly invested in immovable assets, and (ii) real estate investment funds. Specifically: investment funds, other than real estate funds, are deemed to be resident in Italy for income tax purposes and, in principle, liable to tax in Italy. Under art. 73-quinquies of the TUIR (*Testo Unico delle Imposte sui Redditi*) proceeds realized by Italian investment funds are generally exempt. However, a number of exceptions apply (*i.e.* SICAVs and SIFAFs are subject to the same income tax regime applicable to domestic investment funds). Instead, real estate investment funds are not subject to IRES and IRAP. However, in some cases a withholding tax of 26% is applied.

7.2.1 Foreign funds

Foreign investment funds, whether or not having legal personality, are subject to Italian corporate income tax for domestic income produced in Italy.

7.2.2 Taxation of the fund management

Italian investment funds may only be operated by funds' management operators. The management company is subject to ordinary corporate income tax and is regarded as a financial entity. The management fees and the income received for the activity carried on are tax relevant, for IRES and IRAP purposes.

7.2.3 General principles

7.2.3.1 Carried interest

Recent guidance issued by the Italian tax administration determined that qualifying carried interest proceeds will be treated as investment income taxed at a flat rate of 26% (as opposed to employment income taxed at progressive tax rates up to 43% plus surcharges) when received by managers and employees holding shares, quotas or other similar financial instruments having "enhanced" economic rights, or by investment undertakings or other persons controlling or managing the fund (falling within the definition of variable remuneration). The provisions subject to a number of conditions. In brief:

- the issuer of such shares, quotas or other similar financial instruments must be tax-resident (or collective investment undertakings instituted) in Italy, or in a jurisdiction allowing for an adequate exchange of information with Italy;

- the effective disbursement shall represent an amount not lower than 1% of the net equity of the relevant qualified entity (or 1% of the total investment of the qualified entity if this is an investment undertaking);
- the payment of proceeds from shares, quotas or other financial instruments to managers is deferred after all the other shareholders and/or unitholders have received an amount equal to the invested capital plus a minimum yield, as set out by the articles or regulations of the fund;
- the shares, quotas or other financial instruments have been held by such managers or employees for at least five years or, if earlier, until the date of change of control on the relevant entity or change of the management company of the collective investment undertaking.

Carried interest received by the Italian management company for the activity carried out is included in the relevant income tax basis for IRES and IRAP purposes.

7.2.3.2 Management fees from business acquisition. Accounting and tax treatment

Management costs deriving from business acquisition in case of private equity transactions may be comprised in the definition of “other relevant costs” (*see* section 7.1.1). Thus, they should be booked into the profit and loss accounts and could generally be considered as deductible costs. However, a case-by-case approach should be envisaged.

7.2.3.3 VAT on carried interest

From a general VAT perspective, it must be noted that payments of carried interest proceeds are exempt under Italian VAT law.

7.2.3.4 VAT on management fees

From a general VAT perspective, management fees paid by the fund to the Italian management company are tax-exempt. However, it is worth noting that the management company is subject to the VAT pro-rata method if it carries out other business activities subject to tax under the Italian VAT Law.

8 Good Leaver and Bad Leaver Provisions

The manager’s competence and personal experience is a key element to private equity investors because the marketing activity concerning the target company is often conditioned by the reputation and qualities of the individuals that are granted effective powers in the conduct of the business. Therefore, in order to avoid pitfalls, management agreements providing for clauses concerning the conditions of early termination of the designated managers are common practice in the Italian private equity market. Such clauses relate to the stake in the company that is already held by the manager, as well as the treatment of any stock options. The effects of a manager’s early termination depend on its underlying reasons.

8.1 Valuation of share

A “good leaver” clause considers the situation of a manager’s dismissal without just cause or voluntary resignation or dismissal or resignation for serious objective or physical and mental health conditions impeding the performance of their managerial functions. In such cases, the consequences of early termination usually depend on the duration of the relationship between the company and the manager and the state of the investment. Generally, a dismissed manager may exercise, to a certain extent, his stock option rights, and the price shall be calculated in proportion to the results achieved by the company prior to termination.

8.2 Payment

Bad leaver clauses, such as those concerning the dismissal of the manager by the company for just cause or voluntary resignation of the manager without just cause, provide for the investors’ entitlement to exercise a call option right over the dismissed manager's stock at a discounted price. Bad leaver clauses should also consider the risks faced by private equity investors operating in Italy according to ruling no. 16601 of 5 July 2017 issued by the Italian Supreme Court. Such ruling allows the enforcement of foreign judgements providing for the payment of punitive damages despite the incompatibility of such damages with the Italian system (which recognizes the payment of damages as a compensation for losses or harms suffered by the injured party) upon condition that such judgements must derive from a legal system that recognizes them.

9 Taxation of Investors

9.1 Domestic investors

9.1.1 Individuals

In case of Italian investment funds, taxation of investors is generally made according to art. 26-quinquies of the Decree of the President of the Republic no. 600 of 29 September 1973, whereby proceeds deriving from the fund's units are subject to a final withholding tax at 26% if the individual is acting outside a business activity. A 26% withholding tax is also levied to persons carrying out a business activity where the fund's units are held as business assets. However, in this case the tax withheld is not final so that proceeds must be declared in the income tax return and taxed in accordance with the progressive tax rates of the unitholder.

9.1.2 Institutional investors

Proceeds distributed by Italian investment funds to other domestic investment funds do not give rise to any taxation, as they are exempt from income tax.

9.1.3 Entitlement to benefits under double tax treaties

The application of treaty benefits to institutional investors in relation to income realized by foreign funds depends, primarily, on the legal status of the investment vehicle. If the vehicle is not treated as a legal person under domestic law, it is still doubtful if it can qualify as a "person" for treaty purposes (thus, be considered as "liable to tax" in Italy).

9.2 Foreign investors

9.2.1 Individuals

Non-resident investors are generally subject to a final withholding tax at 26%. However, under the provisions set forth by Legislative Decree no. 239 of 1996, no withholding tax will apply if non-residents provide the authorized intermediary with a declaration of beneficial ownership and a certification of tax residency in a Country that allows an adequate exchange of information with Italy.

9.2.2 Institutional investors

The same provisions illustrated in section 9.1.2 apply. However, the withholding tax is not applied if non-resident investors qualify as supranational entities and organizations, central banks or professional investors (as defined under art. 100 of Financial Tax Act). The same considerations apply in case of distributions made by Italian real estate funds.

In case of dividend distributions, a final withholding tax at 26% will apply, unless treaty reductions operate (*see* section 9.1.3).

9.2.3 Entitlement to benefits under double tax treaties

Application of treaty benefits to foreign investors, in relation to income distributed by Italian investment funds, is allowed in proportion to the corresponding interest in the fund's units.

10 Taxation of Cross-Border Mergers and Acquisitions

10.1 General tax principles deriving from extraordinary transactions

This chapter focuses on merger and demerger transactions. The main implications from asset and share deals are discussed in chapter 11 below.

As a general rule, cross-border transactions compliant with the EU framework are subject to the same tax treatment provided for domestic transactions. In contrast, any transaction which falls outside the scope of the EU Merger Directive, is subject to taxation in Italy (if any) and the provisions of art. 13 of the relevant bilateral tax treaty would take place. For domestic tax purposes, merger and demerger transactions are tax neutral operations regardless of whether the resident merging company adopts Italian GAAPs or IAS/IFRS principles. Accordingly, capital gains arising in the hands of the merging or de-merged resident company do not constitute neither a taxable event nor a tax savings.

10.2 Tax treatment of positive merger differences: goodwill

In case the merger deficit is allocated to goodwill, the buyer may book this value on the balance sheet for accounting purposes only. Therefore, the goodwill should not be relevant for IRES and IRAP purposes and, as such, not be amortized for tax purposes unless a step-up of the value is made (paying a substitute tax in proportion to the stepped-up value: tax rate at 12% up to EUR 5 million, at 14% between EUR 5 million and EUR 10 million and at 16% on the portion that exceeds EUR 10 million).

11 Exit Strategy for Funds

11.1 Asset deal: overview of tax implications

In an asset deal realized through a transfer of assets, the operation concerned is tax neutral as far as it is realized between resident companies, and either the transferring or the receiving company is a non-resident entity with a permanent establishment in Italy. Therefore, outside the scope of application of the EU Merger Directive there are not special rules for cross-border asset deals. By contrast, for domestic asset deals the provisions reported in section 10.1 are generally applicable.

11.2 Share deal: overview of tax implications

Generally, a share deal may be structured either by way of an exchange of shares or by a share acquisition. The specific tax issues depend on the structure chosen. In the case of exchange of shares, whereby the transaction involves an Italian company and a foreign company resident in another EU Member State, rules governing the EU Merger Directive may apply. In this situation, the requisite of substantial participation required by the Law must be determined under the definition of art. no. 2359 of the Italian civil code.

In the case of share acquisition, any gain from the disposal of shares in target companies may be taxable in Italy under certain limits, provided that the requirements for the participation exemption regime are met.

11.3 Taxation of capital gains from the disposal of shares for funds

11.3.1 Resident funds

According to the special tax rules established by art. 73(5-quinquies) of TUIR (*see* section 7.2), capital gains realized by Italian investment funds from the disposal of shareholdings in target companies are exempt from taxation. Accordingly, resident and non-resident investors receiving proceeds from the Italian investment funds will be taxed following the rules highlighted before (*see* sections 9.1.1 and 9.1.2).

11.3.2 Non-resident funds

11.3.2.1 Whether a double tax treaty with the other jurisdiction is in force

Once the turnaround process of an Italian target participation is achieved, the foreign fund can start the exit process. Based on the rules provided by art. 13 of the OECD Model Tax Convention, capital gains that may arise from the sale of shares in an Italian target company could be, in principle, taxable only in the Country of residence of the selling company, to the extent that the foreign shareholders qualify as beneficial owners.

11.3.2.2 Whether a double tax treaty with the other jurisdiction is not in force

In the event that the Country of residence of the foreign fund did not sign any bilateral tax treaty with Italy, the latter may be entitled to tax the capital gains arising from the disposal of an Italian target company.