Italian Acquisitions by Foreign Investors: Impact of Tax Reform

Paolo Troiano
Studio Legale Macchi di Cellere Gangemi, Milan

ITALY

In my article published in January 2003,[1] based upon the first draft of the Italian tax reform, I explained why today's tax planning schemes to acquire shares of an Italian Target, will be strongly affected by the reform of the Italian tax system. In fact, today's tax strategies will have to be reconsidered bearing in mind that the new tax law framework will be more favourable to vendors than to purchasers. Further to the final approval of the Tax Reform on September 12, 2003, the purpose of this article is to outline the provisions which are of interest to M&A professionals, and provide some first ideas on alternatives tax efficient structures to be used after January 1, 2004, the date the new régime enters into force.

I. Introduction

The reform of the Italian tax system was approved by the Italian Government on September 12, 2003 ("Tax Reform"). Minor changes to the provisions of the Tax Reform are still possible and, in the contest of a legitimate lobbying activity, a number of associations have already proposed amendments.

In my previous article on the subject, I outlined today's most common planning schemes used by foreign investors to acquire an Italian Target, and briefly indicated the impact the proposed tax reform would have on the same, based upon the Tax Reform guidelines provided for by law 80/2003.

The Bill being now in its final version, the object of the present article is to confirm which tax planning schemes will be no longer available and from what date: in this respect it should be noted that although Tax Reform will be effective from January 1, 2004, certain provisions will come into force at a different date.

After having dealt with "*what is no longer possible*", I will start looking into possible alternatives and consider how acquisitions of Italian Targets will, most likely, be structured in the future. I will consider income tax issues only, as the Tax Reform left unchanged today's rules regarding indirect taxation.

II. Provisions to be Considered when Acquiring Shares of Italian Target

I will consider the purchase, by a foreign investor, of shares of an Italian company ("Target"). As an alternative to the acquisition of Target shares directly, or through a third-country holding company, the use by the foreign investor of an Italian Special Acquisition Vehicle ("SPV") was, and will probably continue to be, a common route to optimise the taxation aspects of the post-acquisition phase.

To fully understand the tax planning schemes used today to acquire shares in an Italian Target, I will explain the main features of the Italian tax provisions of interest in the context of M&A activity.

I will then explain which changes to the Italian Tax Code ("ITC") will affect today's tax planning schemes used by foreign investors dealing with an Italian acquisition ("New Rules").

A. Fiscal Unit Régime and Tax Credit Attaching to Dividend Payments

Italian corporations are subject to corporate tax ("Irpeg") levied at 34 percent and local income tax ("Irap") levied at 4.25 percent. Currently, companies pertaining to the same group cannot opt for a fiscal unit régime for Irpeg/Irap.

However, domestic dividends may generate, provided certain conditions are met, tax credits available to be surrendered within the same group of companies (but only between companies that are both tax resident in Italy), thus enabling them to obtain a result close to the one normally achieved with a fiscal unit régime, that is, the compensation of the tax results of a loss making parent company with the ones of a profitable subsidiary.

In fact, domestic dividends (*i.e.*, profit distributions between Italian resident companies) are taxed under an imputation system régime according to which a notional tax credit is given to the dividends recipient. The dividend recipient's taxable income is calculated by grossing up the dividends received by adding the said notional tax credit, Irpeg is then calculated on the aggregate of the dividends and the tax credit, the latter being then available as a credit. As a consequence of such calculations, dividends payments from an Italian subsidiary to its Italian parent company will not suffer any additional tax.

In the case of a loss making parent company, dividends income did generate an excess tax credit that, provided certain conditions were met, was available to be surrendered to a group company (*e.g.*, the same subsidiary paying the dividend). One of the conditions for the tax credits to be available to surrender was for the profit distribution to carry the so called full tax credit ("Tax Credit Basket A"), rather than the limited tax credit ("Tax Credit Basket B"). The former tax credit being available when the distributing company had always paid the full Irpeg rate, the latter being generated in the case of profits distributions arising from income which did not suffer the full Irpeg rate (*e.g.*, dividends income received from a E.U. subsidiary which could benefit from the E.U. parent-subsidiary directive).

The tax credit attaching to dividends payments was, therefore, a valid means to:

1. obtain a *de facto* fiscal unit régime; and/or
2. accelerate the use of tax losses carry forward if these were with a parent company having profitable subsidiaries.

As previously explained, under case 1. the *de facto* consolidation was obtained as a consequence of dividends payments from, say, a profitable subsidiary to a loss making parent company, or one with tax losses carry forward. The parent company then surrendering the tax credit attached to the dividends received to its profitable subsidiary, a tax credit then used to compensate the Irpeg/Irap due.

The same concept applies in case 2., this was a common scheme in cases of tax-loss making companies which, due to the five year carry-forward rules provided for by article 102 of the ITC, did not expect to generate sufficient profit to fully utilise their tax losses. The tax strategy was to transfer to the said company's subsidiaries, with profits carried forwards having a full Tax Credit Basket A. The subsidiaries then distributed their profit reserves to materialise a tax credit available to surrender.

I. The new rules:

A participation exemption régime will be introduced in respect of dividends received by Italian resident companies from Italian and foreign subsidiaries.

As a consequence of the dividends (partial) tax exemption régime, today's imputation system will be abolished from January 1, 2004.

Not entirely satisfied with the rules introduced by the Tax Reform, the Italian Government, with Law Decree no. 269 dated September 29, 2003 ("Decree 269/2003"), Article 40, named "*Anti-avoidance provisions on tax credit*", ruled that profits distributions, resolved after September 30, 2003, and until the end of the tax period in force on December 31, 2003, will only benefit from the (limited) Tax Credit Basket B.

Therefore, Article 40 of Decree 269/2003, has *de facto* anticipated to September 30, 2003 the last available date for Italian subsidiaries to resolve profits distributions enabling to benefit from the (full) Tax Credit Basket A.[2]

Last, but not least, it should be noted that according to Article 2366 of the Italian Civil Code, notice of joint stock Companies shareholders meeting has to be published on the Official Gazette at least 15 days before the same meeting.

Article 40, Decree 269/2003 was approved on September 29, and in force from October 1, it is therefore of evident that joint stock Companies were not given sufficient time to convene shareholders meeting to resolve profit distributions, we may well argue that the law was *de facto* retroactive.[3]

Therefore, tax planning schemes used to exploit tax credits attached to dividends payments, in presence of a loss making parent company, are already obsolete.

In line with tax systems of most E.U. countries, after having abolished the dividends imputation system, which could be looked at as the Italian way of obtaining a fiscal unit régime, Italy introduced with articles 118 to 131 of the New Italian Tax Code ("New ITC"), the option for companies within a group to file a sole tax return and offset their results for tax purposes ("The Fiscal Unit régime").

The rules governing the Fiscal Unit régime are extremely complex and detailed, for the purpose of our analysis the possibility to opt for the consolidation of non-Italian resident companies also is of interest.

However, tax losses carry forward for companies entering a Fiscal Unit will only be available with the company who generate the said tax losses, this means that SPV incorporation and closing date will have to be carefully considered to ensure SPV does not generate tax losses before the option for the Fiscal Unit régime.

B. Goodwill Depreciation and M&A Transactions

The basic rule is that goodwill can be depreciated for tax purposes only if effectively paid for, in the contest of a purchase of a going concern (*i.e.*, the so called "*acquisto d'azienda*").

According to article 68 of the ITC, goodwill is tax deductible in a ten year period. The rules governing the tax deductibility of goodwill being unchanged under article 104 of the New ITC.

In case of a share deal, such as the one under analysis, the goodwill will materialise only as a consequence of SPV merger with Target, the difference between the consideration paid for Target shares, and the latter company net equity, giving rise to the so-called "merger deficit" further to the merger.

From an accounting perspective, the merger deficit will be allocated to Target fixed assets now with SPV, the remaining part being booked as goodwill. From a tax perspective, according to Law 358/1997, the goodwill will be recognised for tax purposes only to the extent:

1. the capital gain realised by the vendor(s) has been subject either to Irpeg or the 19 percent substitute tax, if realised by resident companies, or the 27 percent capital gain tax in case Target shares are sold by individuals or non-resident companies ("The Tax Free Step Up"); or
2. in cases where the Tax Free Step Up is not available, SPV elects to pay a 19 percent substitute tax, to be calculated on the full merger deficit or on the part of the merger deficit which the company chooses to step-up ("The Onerous Step Up").

The tax utilisation of the merger deficit would consist of the depreciation of the goodwill (in ten years) and/or of the increased value of Target assets (according to a straight-line method and over a period of time which varies, under Italian tax law, depending on the category the assets belong to). Such tax relief would obviously be enjoyed at the effective Irpeg/Irap rates.

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The potential benefits of the tax depreciation of the increased values resulting from Target merger into SPV are of course subject to anti-avoidance provisions. Sound business reasons should exist in each individual case. It is my opinion that these should support both SPV incorporation and the subsequent merger with Target, timing may also play an important role in this respect.

1. The new rules

The Irpeg rate, currently at 34 percent, will be reduced to 33 percent from the year 2004. There is also a proposal to gradually abolish Irap, however in the Tax Reform the relevant rules have not been modified yet.

Where the Tax Free Step Up is not available, the overall reduction in the Irpeg/Irap tax burden will render less convenient to obtain the recognition of the merger deficit by paying the 19 percent substitute tax. In effect, the lower the overall Irpeg/Irap tax rates are, the less convenient is to sustain a 19 percent charge today in light of tax savings only available in a ten year period as a consequence of the goodwill depreciation.

According to article 4 of the rules governing the entry into force of the New ITC, the possibility to obtain the recognition of the merger deficit by paying the 19 percent substitute tax, the so called Onerous Step Up, will be abolished for merger effective after January 1, 2004.

In addition, also the Tax Free Step Up will no longer be available for mergers resolved after April 30, 2004.

Once the possibility to obtain the tax recognition of the merger deficit, whether by using the Tax Free Step Up or the Onerous Step Up, will not be available any longer, SPV merger with Target will not be of any use to materialise the goodwill paid and incorporated in the latter company shares. Therefore, in the case of a share deal and subject to financing issues, the use of an Italian acquisition vehicle will lose (part of) its appeal.

C. Thin Capitalisation Anti-Avoidance Provision

Another relevant feature of today's Italian tax system is the absence of any debt to equity ratio anti-avoidance provision (*i.e.,* the so called "thin capitalisation" rules). In principle, Italy grants full relief for interest expenses, provided these are incurred wholly and exclusively for the purpose of the business. However, interest is not deductible for Irap purposes.

1. The new rules

Article 99 of the New ITC[4] has introduced thin capitalisation anti avoidance provision, according to which the tax deductibility of interest payments on loans, granted or guaranteed, by qualified shareholders, and related parties, will be disallowed if the debt to equity ratio of the borrowing company exceeds 4:1 ("Excess loan").

A qualified shareholder is any one holding, directly or indirectly, 10 percent or more of the issued share capital of the borrowing company, related parties are companies controlled by qualified shareholders according to article 2359 of the Italian civil code.

The debt to equity ratio is calculated by taking into account:

- *Debts*: all loans granted or guaranteed by qualified shareholders and related parties, including mortgage, cash deposit and any other relationship of a financial nature are assimilated to guarantees and collateral, any behaviour and actions which, even if not legally qualifying as a guarantee, enable to obtain the same effect; and
- *Equity*: the net equity pertaining to the qualified shareholder and his related parties.[5]

However, interest payments will remain tax deductible if the borrowing company could demonstrate that the excess loan arose from its own credit capacity rather than from the shareholders one.

In addition, thin capitalisation anti-avoidance provision will not apply where the borrowing company turnover is not in excess of the threshold provided for by the so called "*studi di settore*" (approximately Euro 5m).

D. Other Rules Introduced by the New ITC

1. Interest deductibility pro ratio

Interest payments which have passed the thin capitalisation test, will only be tax deductible for the amount not exceeding the (borrowing company) ratio:[6]

$$\frac{\text{Qualifying Shareholding}^{a} - \text{Net Equity}}{\text{Total Assets} - \text{Net Equity} - \text{Commercial Debt}}$$

a Qualifying shareholdings are the ones following within the participation exemption régime.

This anti avoidance provision is devised to affect highly leveraged holding companies' interest tax deductibility.

The interest deductibility pro ratio anti-avoidance provision will not apply in case the borrowing company opts, together with its qualifying subsidiaries, for the

- Fiscal Unit régime; or
- the tax transparency régime.

Being that this anti-avoidance provision unknown in other jurisdictions, its impact will have to be monitored. However, at a first glance, it is my opinion that the Pro Ratio will be more detrimental to tax payers interest tax deductibility than thin capitalisation rules.

In fact, it should be noted that, according to Article 99, paragraph 2, thin capitalisation will not apply altogether in cases where the borrowing company is able to demonstrate that the excess loan might have been granted by an independent third party, with the sole guarantee of its assets. On the contrary, to avoid the Pro Ratio, we will be forced to opt for the fiscal unit régime or the transparency one, this might be difficult, or inconvenient, in case of minority states and/or non Italian resident subsidiaries.

In the latter case, we would have to opt for the World Wide Fiscal Unit Régime which appear to be extremely burdensome and inconvenient.

2. Tax transparency

With the tax transparency rules, provided certain conditions are met, the income of the subsidiary is directly taxable in the hands of the parent company. In practice, with the tax transparency régime, we achieve a similar result to the Fiscal Unit one.

3. Profit participating loan

According to article 110, paragraph 9, letter b) of the New ITC, payments under a profit participating loan (under Italian law named "*Associazione in Partecipazione*") are no longer tax deductible in case the object of the contribution is other than services (*e.g.*, cash).

Therefore, in the case of loan agreements where the consideration is calculated having regard to SPV results (*e.g.*, profit before tax), it is questionable whether these will have to be amended to avoid the application of the above rules and the interest payments being non-tax deductible.

4. Participating exemption régime

Radical changes have been introduced in respect of the taxation of dividends / capital gains from qualifying subsidiaries.

Dividends will remain taxable on a cash basis, however according to article 90 of the New ITC, provided certain conditions are met, profit distributions made by resident and non-resident[7] subsidiaries should be taxable only up to five percent of their amount.

The (partial) exemption régime also applies to interest payments disallowed according to the new thin capitalisation anti-avoidance provision, provided for by article 99 of the New ITC, and payments received under profit participating loans, see Section II.D.3., above.

According to Article 88 of the New ITC, capital gains realised from the disposal of shares and quotas in Italian resident and non-resident subsidiaries, will be tax exempt provided the participation in question:

1. has been held with continuity from at least 12 months; and
2. was booked as a financial fixed asset in the first accounts after the acquisition date; and
3. is not in a company resident in a tax haven; and
4. is in a company carrying out a business activity, real estate companies do not fall within the definition.

In case of disposal of interest in an holding company, conditions 3. and 4. have to exist in the latter company subsidiaries.

E. Interest Payments to non-Italian Residents: Withholding Tax at Source

At present, according to article 26, paragraph 5, of Law 600/1973, interest paid by an Italian resident company to a non-resident one, are subject to withholding tax at source levied at 12.5 percent, or 27 percent where interest is paid to a tax haven-resident company.

This holds true even where there is the protection of a double tax treaty (in which case, the withholding tax rates are generally reduced as compared to the domestic ones).

Where the SPV is financed by a non-Italian resident entity, interest withholding taxes may not be a material issue to the extent the foreign lender has foreign tax credit capacity. If this is not the case, it should also be mentioned that back-to-back arrangements, to avoid Italian withholding tax, are difficult to implement as they are tackled by specific anti-avoidance provisions.

1. The new rules

From January 1, 2004, according to the E.U. directive 2003/49 ("E.U. Directive"), interest payments made between E.U. resident companies belonging to the same group, provided certain conditions are met, will be exempt from withholding tax at source ("nil withholding tax régime").

The E.U. directive was approved at the Ecofin meeting held on June 3, 2003, and published on June 26, 2003, in the Official Journal of the European Union.

A E.U. resident company will take advantage of the above mentioned nil withholding tax régime on cross border interest payments, provided the following main conditions are met:

- the beneficial owner of the interest is a company of another member State or has a permanent establishment situated in another member State; and
- payer (*e.g.*, SPV) and beneficiary shall be incorporated in one of the forms provided for by Annex 1 of the E.U. Directive (*e.g.*, in case of Italy S.p.A. or S.r.l.), and subject to corporate tax in its country of residence without the possibility of being exempt; and
- payer and beneficiary belong to the same Group (the "Associated Company" condition). This condition is deemed to exist where the shareholding interest is at least 25 percent. More specifically two companies are associated where:
  - the first company has a direct minimum holding of at least 25 percent in the capital of the second company; or
  - the second company has a direct minimum holding of at least 25 percent in the capital of the first company; or
  - a third company has a direct minimum holding of at least 25 percent in both the capital of the first and the second company.

It should be noted that the participation has to be a direct one, according to most authors interpretation and having regard to the E.U. Directive first draft, indirect participation should not be taken into account.[8]

The E.U. Directive contains a number of provisions for the prevention of fraud and abuse and has left to the single member State to decide upon certain matters regarding the conditions to benefit from the nil withholding tax régime. In particular, each member State (*e.g.*, Italy) has the authority, on certain aspects, to implement the E.U. directive with a certain degree of flexibility which, however, is well capped and defined.

With regard to the level of flexibility left to the single member State (*e.g.*, Italy) in the implementation of the E.U. directive, it should be noted that:

- a member State shall have the option to not apply the E.U. Directive if the conditions set out in article 3(b) (*i.e.*, payer and beneficiary have to be Associated Companies) have not been maintained for an uninterrupted period of at least two years; and

- the source State may require the fulfilment of the requirements to be substantiated at the time of payment of the interest by an attestation. A ruling on exemption might also be required and has to be provided within three months after the request; and
- in the definition of Associated Company, a member State shall have the option to replace the criterion of a minimum holding in the capital with that of a minimum holding of voting rights.

The E.U. directive also contains a number of anti-avoidance provisions, for example:

- if the amount of the interest exceeds the amount which would have been agreed by the payer and the lender in the absence of any relationship, the nil withholding tax régime shall only apply to the latter amount.
- the interest recipient must be the beneficial owner. A company of a member State shall be treated as the beneficial owner of the interest only if it receives those payments for its own benefit, and not as intermediary (*i.e.*, as an agent, trustee or authorised signatory) for any other person.
- with regard to the Associated Company conditions, this is met if the holdings involve E.U. companies only.
- a member state may withdraw the benefit of the nil withholding tax régime in case of transactions for which the principal motive is to benefit from the said provisions.

As explained above, with the exemption of Greece and Portugal, each member State (*e.g.*, Italy) shall bring into force the laws, regulations and administrative provisions necessary to comply with the E.U. Directive not later than January 1, 2004, date of effect of the provisions introducing the nil withholding tax régime on interest payments.

III. Acquiring an Italian Target: Tax Efficient Structures

The main goal of a tax adviser, when dealing with cross border acquisitions, is to ensure that:

- financial charges, due on the financing needed to fund the acquisition, are tax deductible from the income of the same Target; and
- the goodwill paid, and incorporated in the consideration for Target shares, is recognised for tax purposes and depreciable as such.

The direct acquisition of Target, by the foreign investor, does not enable the latter to benefit from any planning opportunity, for example, to reduce Target taxable income, as a consequence of the acquisition, by means of interest payments to a group finance company based in a favourable jurisdiction.

A. Today's Planning Techniques: Brief Analysis

At present, to obtain relief for interest payments on the financing for the acquisition, and obtain the recognition of the goodwill paid and incorporated in the consideration for Target shares, the strategy is to route the deal via an Italian SPV, followed by a merger with Target.

After having briefly outlined the content of today's tax strategy, I will explain the reasons and the extent this is affected by the New Rules provided for by the Tax Reform and outlined in Section II, above. For a full description of the rationale behind today's tax strategy, please refer to my previous article.[1]

I will deal with today's, and future, tax strategy having regard to the two main goals indicated above, which a tax adviser should take care of in the contest of M&A transactions.

1. Financial charges

In the absence of thin capitalisation anti-avoidance provisions, further to SPV and Target merger, interest payments arising from the loan contracted by the former company to finance the acquisition of the latter one, are directly tax deductible against Target income.

In addition, tax relief for SPV interest payments was also available before (and without) the SPV/Target merger, this using the possibility to surrender to a group company the tax credit arising from dividend payments.

In fact, assuming SPV did not have any other source of income, upon Target dividend payments carrying a Tax Credit Basket A, interest payments did generate an excess tax credit which was available to be surrendered to the same Target and used by the latter company to reduce the Irpeg/Irap due.[9]

As explained in Section II.A., above, the latter tax strategy is no longer available for distributions resolved after September 30, 2003, in fact, profit distributions resolved after this date will only benefit from the so called Tax Credit Basket B which, by law, cannot be refunded nor surrendered to a group company.

Therefore, as a consequence of the above measure, the use of an Italian SPV to acquire Target shares will enable to obtain relief for interest payments only in case the latter company and SPV are merged or we opt for the Fiscal Unit régime.

In addition, the use of a highly leveraged Italian SPV will have to be considered in light of

1. Thin Capitalisation anti-avoidance provision; and
2. Pro Ratio interest tax deductibility.

With regard point to point 1. it should be noted that SPV assets will be represented by Target shares only, this being a typical LBO transaction.

As advised in Section II.C., above, SPV will be able to obtain the full tax deductibility of interest payments, in case of a debt to equity ratio in excess of 4:1, only where is able to demonstrate that the excess loan arose from its own credit capacity rather than from the shareholders one.

It may be questioned whether, in the case of a LBO transaction, such as the one under analysis, any loan is granted to SPV just having regard to the same company credit capacity, this being represented by the shares in Target, or Target underlying assets.[10]

To avoid the application of the Pro Ratio interest tax deductibility, SPV and Target should opt for the Fiscal Unit régime. In case Target is then merged into SPV no recapture should occur, however clarifications are needed on this point.

The above mentioned anti avoidance provisions, affecting the tax deductibility of interest payments, are alleviated by the provisions of the E.U. Directive. In fact, the absence of any interest withholding tax at source may be, in certain case, a considerable saving at a group level which may well compensate the fact the interest payments are – in part – disallowed.

2. Goodwill (tax) depreciation

The use of an Italian SPV to acquire Target is a forced route to obtain the recognition of the goodwill paid.

The goodwill paid upon the acquisition (which also represents the gain for the vendor) would give rise to the so-called "*merger deficit*" in case Target is merged into SPV.

The merger deficit being equal to the difference between the consideration for Target shares and the latter company net equity.

As explained in Section II.B., the tax recognition of the merger deficit is not the normal consequence of the merger, this is granted provided we can benefit from the so called Tax Free Step Up or are prepared to pay the 19 percent substitute tax.

In practice, where we are unable to benefit from the Tax Free Step Up, we will need to evaluate the advantage of paying a 19 percent tax on day one, to obtain a 37.25 percent tax deduction (Irpeg levied at 33 percent plus Irap levied at 4.25 percent) in a 10 year period, this also in light of the proposed abolition of Irap.

As a consequence of the new rules, in case of a share deal, the Purchaser will be unable to depreciate for tax purposes the goodwill paid and incorporated in the consideration for Target shares, this in case of a Target/SPV merger effective after January 1, 2003, where we cannot benefit from the Tax Free Step Up, for merger resolved after April 30, 2004 where we can.

B. New Strategies to Acquire an Italian Target

As a consequence of the Tax Reform, tax advisers will have to devise new tax efficient structures. Bearing in mind what are the objectives of the purchaser, I will outline below some possible alternatives which might be considered in the contest of the acquisition of shares in an Italian Target.

The introduction of a participation exemption régime, together with the abolition of the possibility of giving tax relevance to the merger deficit (*i.e.*, goodwill), means that the law framework is now more favourable to vendors that purchasers. The latter being forced to acquire the business, rather than shares, to obtain the tax recognition of the goodwill paid, the former being interested in selling shares to benefit from the participation exemption régime and cash any capital gain tax free.

However, also under the new rules, to exploit any tax planning opportunity, the foreign investor interested in acquiring Target shares will have to route the same via an Italian SPV. In the following I will consider possible tax strategies to obtain relief for interest payments and depreciate for tax purposes any goodwill paid.

1. Financial charges

Bearing in mind the New Rules described under Section II, to obtain the tax deductibility of SPV interest payments against Target income, we will have, alternatively, to:

1. merge SPV and Target; or
2. opt for the Fiscal Unit régime.

a. SPV and Target merger

In planning SPV/Target merger we will have to take into account the tax-loss carry-forward merger anti-avoidance provision. Tax-loss carry-forward of the merged companies (*i.e.*, SPV/Target) are only available to be carried forward provided certain conditions are met.[10] It has recently being ruled that also share capital contributions upon incorporation will not have to be taken into account in cases where the merger takes place within 24 month from incorporation date. According to this provision, assuming Target / SPV merger will take place within two years from the acquisition date, we will be unable to carry forward any SPV tax losses as the net equity for tax purposes will be nil. Therefore, it is important to minimise interest payments from Target acquisition date to the merger effective date for tax purposes. This could be achieved if SPV is financed with a loan having an interest-free period.

Care should be also given to thin capitalisation anti-avoidance provisions which will deny the tax deductibility of interest paid on the so called exceeding loans, that is, the ones in excess of the 4:1 debt to equity ratio.

In this respect, it should be noted that according to article 99 paragraph 3, letter b) of the New ITC, the debt to equity ratio has to be calculated having regard to the net equity pertaining to each shareholder and related companies. The definition of qualified shareholder is any one holding, directly or indirectly, 10 percent of more in the capital of the borrowing company. Related company is defined as companies controlled by a qualified shareholder.

Within a group we may well have a situation in which the loan to SPV has been granted by a group finance company and we should ensure that in the debt to equity ratio calculation, the latter element (equity) is taken into account in full. For details please refer to the comments made in Section II.C., and on the latter point Footnote 6.

An element of interest in the contest of thin capitalisation anti-avoidance provision, is the proposed introduction of the International Accounting Standards (in the following "IAS") from January 1, 2005. Once the IAS rules will be in force, companies may well decide to revaluate, in all or in part, their fixed assets. This will generate a corresponding reserve posted in the company net equity. Therefore the introduction of the IAS might assist in reducing the possible scope of thin capitalisation, in fact being the borrowing company net equity increased as a consequence of the fair market value rules, the excess loan will be reduced accordingly.

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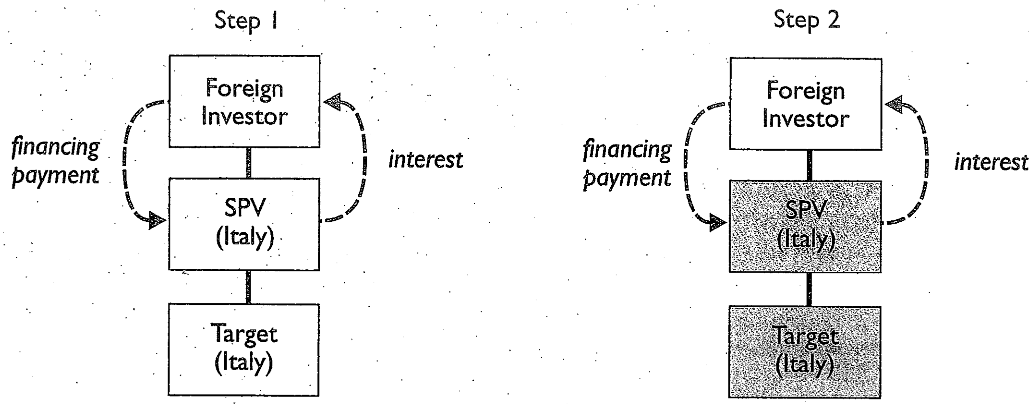
Figure 1



b. Fiscal Unit régime

With the Fiscal Unit régime, SPV interest payments will be immediately tax deductible against Target income.

We may also opt for a combination of option 1. and 2., where Target and SPV are at a first stage consolidated and merged only at a later stage.

The advantage of the Fiscal Unit Option is that SPV pre-merger tax losses are reduced,[12] thus reducing the impact of the merger tax losses carry forward anti-avoidance provisions.

Provided we opt for the Fiscal Unit régime, the anti-avoidance provision known as Pro Ratio will not apply, we further believe that SPV merger with Target will not imply any interest tax deductibility re-capture. See Figure 1.

2. Goodwill (Tax) Depreciation

As a consequence of the new rules, in case of a share deal, the Purchaser will be unable to depreciate for tax purposes the goodwill paid and incorporated in the consideration for Target shares. In fact, the merger deficit arising from Target/SPV merger will not be recognised for tax purposes but for accounting ones only. As explained in Section II, the new rules will apply for merger effective after January 1, 2004 in case of the Tax Onerous Step Up, for merger resolved after April 30, 2004 where we can benefit from the Tax Free Step Up.

a. Proposed business disposal

In case it is planned to dispose of a business, or part of a business, we should consider to contribute the same – at market value – to a newly incorporated company ("NewCo") by December 31, 2003.

This will enable:

- benefit from the 19 percent reduced corporate tax rate on any capital gain realised upon the contribution, and
- obtain a step up in value of the business we are planning to sell.

Therefore, assuming NewCo shares will then be sold at the contribution value, the purchaser will be able to fully depreciate for tax purposes the whole consideration paid and the vendor will benefit from a 14 percent[13] tax rate saving.

The above strategy, to be implemented by December 31, 2003, is, therefore advantageous to both the vendor and the purchaser, a price adjustment may also be agreed to reflect the difference between the consideration for NewCo shares and the contribution value.

3. Other Planning Opportunities

a. Use of an SPV with tax loss carry forward and acquisition of a Target with consistent profit reserves

Before Decree 269/2003, depending on the situation of the Vendor (*e.g.*, an individual, an Italian resident company, a non-resident) the acquisition of a Target company with profit reserves was anticipated by a profit distribution to the vendor. This to benefit from the dividends tax credits, that is, the Vendor cashes part of the consideration in the form of dividends payments, this possibly being more tax effective than realising a higher capital gains.

As a consequence of the elimination of the dividends tax credit, and the introduction of the participation exemption régime, regarding both dividends and capital gains, Target shareholders have no interest in resolving a profit distribution before the disposal to SPV.

However, the introduction of the participation exemption régime might enable to plan a tax efficient merger among a company with tax losses carry forward and a profitable Target.

According to the anti avoidance provision regulating the use of tax loss carry forward in the case of a merger, we are "forced", for the merger to be tax effective, to have the merged companies net equity at least equal to the respective tax loss carry forward,[14] share capital increase and shareholders contribution occurred in the 24 months before the merger financial situation are not taken into account.

Assuming the facts shown in the Table 1:

Table 1

	SPV	Target
Share Capital	50	50
Profit Reserves	<0>	1000
Net Equity	50	1050
Tax Losses Carry Forward	1000	0

Where Target and SPV are merged, the latter company tax losses will only be available after the merger up to 50 (*i.e.*, SPV net equity), therefore 95 percent of SPV tax losses will be lost as a consequence of the merger.

Under the proposed planning, SPV will, before the merger, resolve to distribute Target profit reserves. As a consequence of the participation exemption régime, only five percent of the dividends received will be taxable, and a corresponding amount of SPV tax losses carry forward will be used.

However, the dividend income will enable to increase (i.e. profit to reserve) SPV net equity and, possibly, merge the latter company with Target in a tax efficient way.

In fact, net equity increase as a consequence of profits is not "recaptured" according to the rules that shareholders contributions occurred in the 24 months before the merger financial situations are not taken into account to determine the tax losses available after the merger.

Under the above example, if Target profit reserves are distributed to SPV, the latter company P/L and B/S will look like Table 2:

Table 2

	P/L		B/S
Dividends Received	1000	Share Capital	50
Tax	<0>	Profit Reserves	1000
Profit for the Period	1000	Net Equity	1050

SPV tax losses before the merger will be 950 (*i.e.*, 50 have been used against the taxable dividend income) and will be fully available to be carried forward after the merger as their amount is below SPV net equity.

b. Use of an Italian branch instead of an SPV

Worth considering, is to route Target Acquisition via an Italian branch of the purchaser ("the branch"), rather than via an Italian SPV.

In fact, according to the wording used to define Italian taxpayers subject to thin capitalisation anti-avoidance provision, it is questionable whether an Italian branch of a non resident entity falls within the scope of application of the said rules.[15]

The branch will then opt for the Fiscal Unit Régime with Target, thus enabling to reduce Target taxable income with the branch interest payments.

IV. Conclusions

As a consequence of recent law changes, a number of planning schemes used by foreign investors to acquire an Italian Target are already no longer available, such as the use of tax credits attached to profit distributions.

In addition, on January 1, 2004 the Tax Reform will enter into force and careful planning should be considered in this transition period.

However, also after the mentioned date, to acquire an Italian Target, most likely we will continue to use highly leveraged Italian acquisitions vehicle to obtain relief from the interest payments due on the financing needed to fund the acquisition, this subject to the new anti-avoidance provisions outlined in Section II.

Where it has already being planned to dispose of a business, we should exploit the opportunities still available before the entry into force of the tax reform, to reduce any capital gains tax and obtain a step up in value of the assets of the business in question.

In fact, one of the major changes of the Tax Reform is the impossibility, other than in an asset deal, of obtaining the tax recognition of the goodwill paid and incorporated in the consideration for Target shares. This will have a strong impact over negotiations where purchaser will be less interested to opt for a share deal which, on the contrary, further the introduction of the participation exemption regime, will be the preferred option for vendors.

Paolo Troiano *is the partner in charge of the Milan tax practice of the Law Firm Macchi di Cellere Gangemi and may be contacted at:*
phone: +39 02 763281
fax: +39 02 76 000772

Website: www.macchi-gangemi.com

1 *Tax Planning International mergers & acquisitions*, Volume 2, Number 1, January 2003.

2 With regard the said Article 40 of Decree 269/2003, named "*Anti-avoidance provisions on tax credit*", we are unable to understand why the Italian government, after having fixed a specific date (*i.e.*, January 1, 2004) in which the Tax Reform will enter into force, has taken the view that certain actions (*i.e.*, shareholders resolving to distribute profits) undertaken before the said date, even if in line will today's rules, should be considered as avoidance driven and trigger the application of anti-avoidance provision. In fact, until January 1, 2004, any profit distribution should have been regarded as perfectly legitimate and not representing a route to get around the application of the new tax rules regarding the tax credit abolition.

3 It may be questioned whether the said provisions in legitimate, in fact according to the law implementing the authorities code of conduct with taxpayers, tax law cannot have retroactive effect.

4 **Article 99: Thin capitalisation rules**

1. Payments made in respect of financing facilities as per paragraph 4, granted or guaranteed, directly or indirectly, by a qualified shareholder or his related party, will not be tax deductible in case:

- the ratio between the total amount of the financing facilities, as provided for under paragraph 4, and the net equity pertaining to the same shareholder and his related party, increased by capital contributions made by the same shareholder in compliance with the agreements of article 110, paragraph 9, letter b), exceeds, at any time during the fiscal year, 4:1;

2. Paragraph 1 shall not apply in case the tax payer provides evidence that the amount of the financing facilities, pursuant to paragraph 4, is justified by his own credit capacity and, therefore, the same financing facilities would have been provided by independent parties, with the sole guaranty of the tax payer assets;

3. For the purpose of applying paragraph 1:

- pursuant to paragraph 4, financing facilities are to be considered in excess for the amount exceeding the ratio provided for by paragraph 1, the more onerous financing facilities have to be considered first;
- are related parties companies controlled by qualified shareholders pursuant to article 2359 of the Italian Civil Code and, in case of individuals, relatives, as provided for under article 5, paragraph 5 of the ITC;
- a qualified shareholder is anyone holding, directly or indirectly, at least a 10 percent share of the issued share capital of the borrowing company;
- (....)

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4. For the purpose of determining the ratio provided for under letter a), paragraph 1, relevant financing facilities are those granted or secured by qualified shareholders and related parties. Fall within the definition of financing facilities loans, cash deposit and any other financial arrangement.

5. (....).

6. Debts are intended to be secured by a qualified shareholder or his related parties when backed by real, personal or *de facto* warranties granted by those subjects also by way of actions or behaviour which achieve the same economic effect, notwithstanding they cannot be considered formal warranties.

7. This article shall not apply to tax payers whose turnover does not exceed the threshold provided for the application of sector areas.

5 The definition of "related parties" may trigger some complications in the calculation of the debt to equity ratio. Assuming company A holding the entire share capital of company B and C, the latter companies having a 50 percent interest each in the company D. For the purpose of the thin capitalisation rules A, B, and C will all be qualified shareholders, B and C will be related parties of company A but will not be related parties themselves. Therefore, in case of a loan granted from B to D, this will be fully be taken into account, whether only 50 percent of D net equity will be computed for the debt to equity ratio calculation.

6 **Article 98:Patrimonial Pro-ratio**

1. Where, at the end of the fiscal year, the balance sheet value of shareholding falling within the definition provided for under Article 88, exceeds the net equity, the share of passive interests, after deducting interest income, which remains tax deductible after the application of the anti avoidance provision of Article 99, is not tax deductible for the part correspondent to the ratio of such surplus to the overall assets value, after deducting the net equity and commercial debts. The Interest payments non-deductible part determined as per above, is reduced in proportion to the taxable dividends income relating to shareholdings falling within the definition provided for under Article 88.

2. In order to determine the surplus as referred to in the first paragraph:

- the net equity, including the profit of the period, is reduced according to the same criteria provided for by Article 99, paragraph 3, letter e), numbers 1) and 3);
- are not taken into account:

  shareholding in companies whose taxable results is included in the parent company one according to the Fiscal Unit Régime provided in Sections II and III of this title, with the exception of what provided under Articles 126, paragraph 1, letter a), and 140, paragraph 1 of these Sections respectively;

  shareholding in companies whose income is allocated to the shareholders also as a consequence of the option provided for under article 116. However, in the event such shareholding are sold within three years from the acquisition, the taxable income is incremented for an amount corresponding to passive interests so as deducted in previous fiscal years as a result of this provision.

7 The participation exemption régime will not apply on dividends received from tax haven based subsidiaries.

8 In the first draft of the E.U. Directive, dated March 5, 1998, to define "associated companies" reference was made to both direct and indirect participation. However, at the Ecofin meeting held in May 25, 1999, it was agreed to restrict the scope of application of the E.U. Directive solely to those companies associated by way of a direct capital holding.

9 For details refer to Section II.A.

10 As a member of the Tax and Legal commission of the Italian association of private equity funds, we have drafted a paper requesting the Ministry of Finance to rule that LBO transaction, where, in addition to Target shares, also SPV ones are given as a guarantee in respect of financing obtained by the same company to acquire Target, should not be treated as a guarantee provided by the shareholders.

11 According to article 123, paragraph 5, of Law 22 December 1986 n. 917, the amount of each company's pre-merger tax losses cannot be carried forward after the merger (*i.e.*, of Target into SPV) to the extent their amount exceeds the net equity of each of the merging companies as resulting from the last balance sheets, and without taking into account any equity contribution (whether formal or informal) made in the 24 preceding months. Other specific tests (*i.e.*, the so called activity test) must also be met for the losses to be carried forward after the merger.

12 SPV interest payments will be matched with Target Being the difference between the full corporate tax raincome.

13 Being the difference between the full corporate tax rate levied at 33 percent and the 19 percent reduced rate.

14 Without going into details, as explained above, the merged companies tax losses carry forward will only be available with the company resulting from the merger up to the amount of the merged companies net equity.

15 According to paragraph 1, Article 99 of the New ITC, only loans from qualified shareholders and related parties are taken into account to determine the debt to equity ratio calculation. A branch, by definition, has no shareholders.