Italian Acquisitions by Foreign Investors

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International tax planners advising non-Italian clients acquiring Italian resident companies have to consider the proposed reform of the Italian tax system which, when implemented, will strongly affect today's tax planning techniques used to undertake acquisitions of an Italian resident Target. The purpose of this article is to highlight which of the proposed changes of the Italian tax system will affect today's tax planning schemes used by foreign investors dealing with Italian acquisitions.

I. Introduction

In recent years, Italian tax advisers have conceived a number of tax efficient structures to be used by foreign investors acquiring shares in Italian resident Targets.

However, it is most likely that the alternatives currently available to a foreign investor to acquire shares in an Italian Target in a tax efficient way, will no longer be applicable once the proposed changes to the Italian tax system will come into force.

Further to the General Elections of May 2001, the new Ministry of Finance has proposed a wide reform of the Italian tax system. A Bill containing the guidelines of the said reform is currently pending before the Italian Parliament.

The proposal is for the reform to be gradually implemented over the next few years and should be completed by 2006. The reform has virtually started with Law Decree of September 24, 2002 Number 209 (hereafter 209/2002) which introduces stringent limitations in the rules governing the tax deductibility of participation in subsidiaries write off, this in view of the introduction of a participation exemption régime.

I will start by outlining today's most common planning schemes used by foreign investors to acquire an Italian Target and evaluate the impact the proposed tax reform will have on the same. Object of the analysis will be share deals only, as they are the transactions affected the most by the proposed changes.

II. General Remarks on the Italian Tax System

To fully understand the tax planning schemes used today to acquire shares in Italian Targets, we should get to know some features of the Italian tax system and, in particular, the régime applicable to dividends distributions and applicable anti-avoidance provisions.

Domestic dividends (i.e., distributions from an Italian resident company, to a resident shareholder) are taxed under an imputation system where a notional tax credit is given to the recipient. This tax credit is available to be surrendered to a group company (e.g., the same subsidiary distributing the dividend) or can be fully utilised against the company corporation tax liability ("Irpeg"), however some limitations may occur in case the underlying profits have not suffered full Irpeg taxation (the so-called virtual tax credit). This is the case, for instance, where the distributing company has realised gains subject to the 19 percent substitute tax.

It should be noted that, provided certain conditions are met, capital gains arising from the sale of substantial shareholding or business are subject to a 19 percent substitute tax. The payment of the 19 percent substitute tax, as explained in Section V. A, below, can also be used to obtain full recognition for tax purposes of the so called "merger deficit".

Another relevant feature of the Italian tax system is the absence of any debt to equity ratio anti-avoidance provision (i.e., so-called "thin capitalisation"). In principle, Italy grants full relief for interest expenses, provided these are business-related. However, interest is not deductible for regional income tax ("Irap") purposes, which is currently levied at the rate of 4.25 percent.

Currently, Italy does not have an Irpeg/Irap consolidation régime, however, provided certain conditions are met, tax credits may be surrendered within a group of companies (but only between companies that are both tax resident in Italy).

Finally, of particular interest in a cross-border situation, is the fact that Italy generally levies withholding taxes on virtually all outbound payments of interest, dividends and royalties. This holds true even where there is the protection of a double tax treaty (in which case the rates of the withholding are generally reduced as compared to the domestic ones).

III. Acquisition of an Italian Target by a Foreign Investor

This involves the purchase by a foreign investor of the shares in an Italian Target company ("Target"). As an alternative to the acquisition of Target directly by the foreign investor, or through a third-country holding company, the creation of an Italian vehicle will, as explained in Section V, below, enable to obtain a number of tax related savings.

IV. Indirect Tax Implications

For Italian stamp duties (*fissato bollato*) purposes, it should be noted that in a private acquisition by and between non-financial institutions, the Italian stamp duty is equal to 0.14 percent of the agreed consideration.

In addition, a 0.5 percent registration tax may apply on agreements executed in Italy which provide for onerous obligations of the parties (e.g., personal guarantees, mortgages, pledges, etc) when the guarantees are given by third parties. As provisions of this type are normal practice in share sale agreements, in order to avoid paying the registration tax such agreements are often executed outside Italy or by exchange of letters.

The endorsement of the shares (or the actual transfer of the quotas in cases where the target is incorporated under the form of an S.r.l., that is, a Limited Liability Company), whether in Italy or abroad, is in any event subject to the *fissato bollato.*

V. Direct Tax Implications – Tax Efficient Structures

A. The Use of a Highly Leveraged Italian Acquisition Vehicle

The direct acquisition of Target by the foreign investor does not enable the latter to benefit from any specific planning opportunities and to reduce Target taxable income as a consequence of the acquisition.

In effect, directly acquiring Target shares does not present any planning opportunity in Italy, for instance with regard to the tax depreciation of the goodwill that may be included in the consideration paid to the vendor and obtain relief for interest payments related to the financing required for funding the same acquisition.

A common structure, often used to undertake Italian acquisitions, is to route the same via an Italian acquisition vehicle ("ItalCo."), possibly followed by a merger of the Target into ItalCo. (i.e., the so called up-stream merger).

Although the actual impact of this structure should be carefully considered on a case-by-case basis (also in light of applicable anti-avoidance provisions), it may allow the obtaining of the tax related savings outlined below.

Firstly, interest payments arising from the loan contracted by ItalCo. to finance the acquisition, further to the merger, will be tax deductible against Target income. This may be regarded as a tax efficient way to repatriate funds using interest bearing inter-company loans.

Tax relief for ItalCo. interest payments is also available before the ItalCo./Target merger, thus using the possibility to surrender to a group company the tax credit arising from dividend distributions. Assuming that ItalCo. will not have other source of income, upon Target dividend distribution, the interest payments will generate excess tax credit which, provided certain conditions are met, can be surrendered to the same Target and used by the latter company to reduce its corporation tax liability.

In addition, by acquiring Target shares via ItalCo., it may be possible to recognise for tax purposes the goodwill, if any, "incorporated" in the consideration paid for Target shares.

This can be achieved, with some differences, in two different ways, depending if ItalCo is merged with Target or not. In case ItalCo is not merged with Target the tax deducibility of the goodwill paid upon the acquisition, to be worked out as the difference between the consideration paid and Target net equity, subject to the new rules introduced with Law 209/2002 and explained in paragraph VIII below, can be achieved provided ItalCo. is able to write down its investment in Target tax effectively.

In order to attain a tax participation write-down certain conditions must be met. In general terms, under Italian tax law, a participation write-down in a non-listed company is available for an amount equal to the pro-rata reduction in Target net equity occurring between the date of the last balance sheet prior to the acquisition and the most recent balance sheet. This implies that a tax write-down of the investment in Target is available insofar there have been operating losses or dividend distribution.

However, according to the new rules which should be shortly approved by the Italian Parliament, no relief will be given in case the net equity reduction is a consequence of dividend distributions. Additional conditions must be met for a participation write-down to be tax deductible, for details refer to Section VI, below.

Alternatively, the goodwill paid upon the acquisition (which also represents the gain for the vendor) would give rise to the so-called "merger deficit" in cases where Target is merged into ItalCo. (i.e., up-stream merger).

The tax utilisation of the merger deficit would consist of the depreciation of the goodwill (in ten years)[1] 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.

The step-up is automatically granted to the extent 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 where Target shares were sold by individuals or non-resident companies.

According to law 358/1997, the merger deficit can also be utilised if ItalCo. 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). This is a lump-sum substitute tax, levied in one instalment and due even in case ItalCo. is in a tax loss making position. The 19 percent substitute tax is not deductible for Irpeg purposes.

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In practice, today, we will need to evaluate the advantage of paying a 19 percent tax on day one to obtain a 40.25 percent tax deduction (Irpeg levied at 36 percent + Irap levied at 4.25 percent) in a 10 year period, this also in light of the proposed tax rate reductions to be implemented in the next few years.[2]

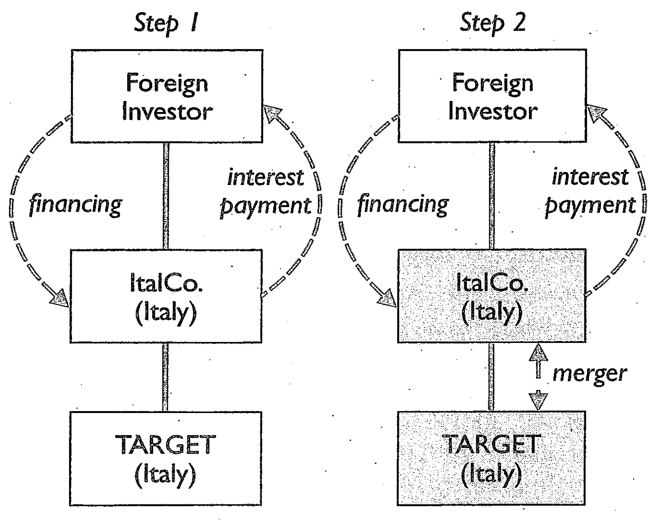
The potential benefits of the tax depreciation of the increased values resulting from Target merger into ItalCo. are of course subject to anti-avoidance provisions. Sound business reasons should exist in each individual case. It is my opinion that these should support both ItalCo. incorporation and the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

A business reason for the incorporation of ItalCo. would probably be deemed to exist where the foreign investor is willing to use the same company to coordinate all of the Italian activities (e.g., in case it is planned to acquire a certain number of Italian companies).

The subsequent merger, in turn, could be acceptable if the original strategic decisions which lead to ItalCo. incorporation were no longer applicable because of changes in the Italian market, or due to changes in the strategic policy of the foreign investor which no longer justify the existence of an Italian sub-holding company. (See figure below.)

With regard to interest payments, in case ItalCo. is financed by a non-Italian resident entity, interest withholding taxes will be levied on interest payments. This may not be a material issue to the extent that 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 be implemented as they are tackled by specific anti-avoidance provisions.

The incorporation of a new Italian acquiring company may also bring the benefit of the unlimited carry-forward of the tax losses made in the first three accounting years (as opposed to the ordinary five-years limitation). However, attention should be paid to the limitation provided for by Italian tax law to the carry forward of tax losses following the merger with Target.[3]



B. The Use of a Highly Capitalised Italian Acquisition Vehicle – Dual Income Tax Benefits

The Law of December 18, 1997, No. 466, (hereafter Law. D. 466/97) introduced the so-called "Dual Income Tax" (hereafter DIT) régime, aimed at fostering the capitalisation of companies, i.e., to privilege equity over indebtedness.

The DIT régime applies to resident entities listed in Article 87, para. 1, letter a) and b) of Law 22 December 1986, Number 917 (e.g., joint stock companies, limited liability companies, private and public commercial entities, etc.). It also applies to entrepreneurs, partnerships and Italian permanent establishment of non resident parties.

Under the DIT régime the resident entities listed above (hereafter "the company") are subject to two corporate tax (Irpeg) rates:

- the ordinary corporation tax rate at 36 percent; and
- the reduced corporation tax rate levied at 19 percent.

The *reduced corporation tax rate* applies to the amount of taxable profits corresponding to the deemed *ordinary yield* of the company *capital increase,* to be determined having regard to the company net equity in the tax year in question compared to the one running at September 30, 1996 (hereafter "the tax year of reference").

The *ordinary yield* (to be determined by Ministerial Decree) is related to the performance of public and private bonds.

The *capital increase* is calculated as the difference between the company net equity at the end of the tax year and the net equity of the tax year of reference, decreased by the profits realised for the same period. The *capital increase* is formed by:

- shareholders cash contributions;
- transfers of profits to reserves.

The *capital increase* will therefore be reduced by the amounts of dividend distributions or issued share capital reductions.

In the contest of our analysis it should be noted that also newly formed companies can benefit from this provisions, i.e., companies formed after September 30, 1996.

In this case, the whole initial issued share capital is regarded as *capital increase* for the purpose of the application of the DIT régime, therefore a valid alternative to acquire an Italian Target was to use an Italian acquisition vehicle, strongly capitalised, to benefit from the 19 percent Irpeg rate. Therefore, instead of reducing Target taxable income with interest expenses, the goal is to reduce the average Italian corporate tax rate by benefiting from a 19 percent tax rate on part of the company taxable income.

To evaluate if an Italian highly capitalised acquisition vehicle is more tax efficient than a highly leveraged one, consideration should be given to the tax régime available in the recipient group company country of residence of ItalCo. interest and/or dividends payments. For example, in case ItalCo./Target dividends are taxed under an imputation system régime (e.g., as the one in force in Great Britain) the benefit of the 19 percent tax rate may be lost upon dividend distributions due to a lack of sufficient underlying tax.

It should be noted that the structure outlined above is no longer applicable further to the partial abolition of the DIT régime. New rules have been introduced according to which capital increase made after July 1, 2002 will not be taken into account any longer. Therefore, in case of a new acquisition, no reduced Irpeg rate will be available if the same is financed with equity.

Further limitations to the DIT régime have now been introduced with Law 209/2002. According to article 1, letter c) of the mentioned law, the deemed ordinary yield will be equal to the so called interest legal rate (now three percent) and further limitations are being introduced also affecting existing structures.

VI. New Rules Governing the Tax Deductibility of Unrealised Capital Losses Arising from Interest in Subsidiaries

As explained in Section V. A, participation in subsidiaries, provided certain conditions are met, can be written down for tax purposes.

This could enable structuring the acquisition of an Italian Target via an Italian acquisition vehicle highly leveraged and, even without merging the latter with Target, to obtain relief for interest deduction in Target as a consequence of dividend distributions.

The planning consists in benefiting from the tax credit attaching to dividend distributions which is then surrendered to Target and, at the same time, obtain an additional tax relief deriving from the write-off of the participation in Target. This because the latter company net equity will be reduced as a consequence of the distribution, thus enabling, according to the rules in force, the Italian acquiring entity to write down for tax purposes the interest in the same Target.

According to article 1, letter a), of Law Decree 209/2002 and subsequent amendments currently being discussed with the Italian Parliament, the rules governing the tax deducibility of unrealised capital losses in subsidiaries (i.e., participation write down) have been modified by introducing a number of conditions to be met for the write-down to be tax deductible.

For companies having an accounting period started after the December 31, 2001 and closed after the August 31, 2002, no tax relief will be given in respect of participation write-down deriving from net equity reductions as a consequence of:

- dividend distributions; and
- losses arising from non deductible goodwill depreciation and non-tax deductible provisions.

In case of participation in non-Italian resident subsidiaries, the subsidiary accounting results will have to be adjusted according to the provision of the Italian Tax Code with regard to the treatment of goodwill depreciation and provisions only.

In addition, according to article 1, letter c) of the same law, write-down of shares in subsidiaries booked as fixed assets will only be tax deductible in equal amounts in five accounting periods and realised capital losses exceeding Euro 5 million will have to be reported to the Italian tax authorities to check the possible application of the general anti-avoidance provision of Article 37 bis Law 600/73.

In addition, to the above rules, the proposal to abolish the imputation system (i.e., the tax credit attaching to dividend distribution) will render not tax efficient the purchase of an Italian Target via an Italian vehicle without undertaking a merger.

In this respect, it should be noted that the same law proposal which introduces the guidelines of the proposed tax reform, brings as a justification of the existing imputation system the fact that this enables efficient tax planning schemes for non Italian resident purchasing Italian Targets.

VII. Proposed Reform of the Italian Tax System and Impact on Today's Structures Used by Foreign Investors to Acquire Shares in Italian Targets

As previously explained, a Bill containing the guidelines for an important reform of the Italian tax system is currently with the Italian Parliament. I outline below some of the proposed changes which will affect today's tax planning schemes used by foreign investors dealing with Italian acquisition:

A. Corporate Tax (Irpeg)

The rate, currently at 36 percent, will be reduced to 33 percent.[4] Regional Income Tax (Irap), levied at 4.25 percent, should be gradually abolished.[5] This will render less convenient to obtain the recognition of ItalCo./Target merger deficit by paying the 19 percent substitute tax. In effect, the lower the 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.

B. Abolition of Imputation System

A participation exemption régime should be introduced in respect of capital gains and dividends received by Italian resident companies from Italian and foreign subsidiaries. In particular, dividends received by resident companies should be taxable only on five percent of the amount received.

As a consequence, the current imputation system on dividends received by resident companies will be abolished. When the rules will come into force the use of an Italian acquisition vehicle to acquire Target shares will enable obtaining relief for interest payments only in case ItalCo. and Target are merged, in effect no tax credit available to surrender will exist upon Target dividend distributions.

C. Abolition of Law 358/1997

The reform provides for the abolition of the possibility to give tax relevance to goodwill arising from a merger (i.e., the so called merger deficit) by paying a 19 percent substitutive tax.

It is unclear whether the possibility to obtain the tax free goodwill revaluation will remain.

This will render ItalCo. merger with Target irrelevant and, in case of a share deal and subject to financing issues, the use of an Italian acquisition vehicle will lose its appeal.

D. Thin Capitalisation

Thin capitalisation anti avoidance provision will be introduced under which the tax deductibility of interest payments on loans, granted or guaranteed by shareholders holding 10 percent or more of the issued share capital, would be disallowed if the debt to equity ratio exceeds the established ratio.[6] However, interest payments will remain tax deductible if they are subject to tax in Italy or if the borrowing company could demonstrate that the excess loan arose from its own credit capacity rather than from the shareholders one.

The introduction of thin capitalisation, together with the abolition of Law 358/1997, will affect today's planning schemes based on the use of a highly leveraged Italian acquisition vehicle.

E. Tax Consolidation

According to the law proposal, companies within a group will be entitled to file a sole tax return and offset their results for tax purposes.

Rules will be implemented to regulate the use of tax losses carry forward for companies entering and/or leaving a tax group.

It is still unclear whether this may offer planning opportunities and to what extent.

F. Participation Exemption

As a consequence of the introduction of a participation exemption régime, costs suffered to acquire and manage the said participation, including financial charges, will no longer be tax deductible.

This, again, may affect the use of an Italian acquisition vehicle.

VIII. Conclusion

As a consequence of recent law changes, a number of planning schemes used by foreign investor to acquire an Italian Target are already no longer available, such as the DIT régime scheme outlined in Section V.

New changes are planned and notwithstanding the uncertainty of the rules which will be introduced, it clearly appears that the foreign investor will have to take into account the proposed changes in structuring the acquisition of an Italian Target.

Once the new rules will come into force, acquiring an Italian Target shares via an Italian acquisition vehicle will be less attractive in consideration that:

- the tax deductibility of interest payment to a non resident related party will be subject to thin capitalisation anti-avoidance provision; and
- it is most likely that it will not be possible to give relevance for tax purposes to the goodwill paid for Target shares.

However, planning opportunities may arise as a consequence of the introduction of the tax consolidation régime.

With regard to acquisitions to be finalised before the proposed reform enters into force, care should be given in structuring financing in a way to fall outside the scope of the proposed thin capitalisation rules, this because undertaking a reorganisation of the financing, after the introduction of the said rules, may attract the application of the general anti-avoidance provisions of Article 37 bis Law 600/73.

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1 There are rumours that the goodwill tax depreciation period may be extended from 10 to 20 years.

2 According to the draft Finance Act for the year 2003, Irpeg rate should be reduced down to 34 percent.

3 According to article 123, paragraph 5, of Law December 22, 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 ItalCo.) 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.

4 The draft Finance Act for the year 2003 reduce the corporate tax rate down to 34 percent already.

5 The draft Finance Act for the year 2003 already introduce some relief in respect of Irap.

6 According to the proposed reform different debt to equity ratio will be established having regard to the nature of the company business (e.g., holding companies; manufacturing companies, etc).