Italian Revenue Agency rulings on carried interest

Family Office and Private Client

10 November 2020

Uffici

Milano
Via Vittor Pisani 31, 20124
T: +39 02 676441

Ancona
Via I° Maggio 150/a, 60131
T: +39 071 2916378

Bologna
Via Innocenzo Malvasia 6, 40131
T: +39 051 4392711

Firenze
Viale Niccolò Machiavelli 29, 50125
T: +39 055 261961

Genova
P.zza della Vittoria 15/12, 16121
T: +39 010 5702225

Napoli
Via F. Caracciolo 17, 80122
T: +39 081 662617

Padova
Piazza Salvemini 2, 35131
T: +39 049 8239611

Perugia
Via Campo di Marte 19, 06124
T: +39 075 5734518

Pescara
P.zza Duca D'Aosta 31, 65121
T: +39 085 4210479

Roma
Via Adelaide Ristori 38, 00197
T: +39 06 809631

Torino
C.so Vittorio Emanuele II 48, 10123
T: +39 011 883166

Verona
Via Leone Pancaldo 68, 37138
T: +39 045 8114111

The following document outlines the Italian Revenue Agency's replies earlier this year to queries about the tax treatment of carried interest received by investment fund managers.

The treatment of carried interest under article 60 of Decree Law no. 50 of 24 April 2017

This article introduced a legal presumption that, where certain requirements are met, carried interest received by investment fund employees or managers qualifies as capital income.

When this is the case, these individuals can save considerable amounts of income tax since capital income is subject to 26 percent IRPEF, while employment or equivalent income (the other class of income into which carried interest may fall) is subject to a progressive IRPEF rate ranging from 23 to 43 percent, plus any applicable surtaxes.

For carried interest to qualify as capital income, all of the following three conditions[1] must be satisfied:

— *Condition A*: the overall investment in the fund by all the employees and managers must involve an actual outlay equal to at least 1 percent of the investments made by the investment fund itself.

— *Condition B*: the proceeds from the carried interest rights must accrue only after all the shareholders/unitholders have received an amount equal to their capital investment plus a minimum return stipulated in the articles of association or regulations.

— *Condition C*: the financial instruments bearing carried interest rights must be held for not less than five years.

(1) These conditions are set out in paragraphs a), b) and c) of article 60(1) of Decree Law no. 50 of 24 April 2017.

Tax Rulings no. 407 and no. 435: two different outcomes

In each of the tax ruling applications the Revenue Agency was asked about the treatment of carried interest allocated to investment fund employees when only two out of the three article 60 conditions were satisfied. Specifically, Condition A was not satisfied.

The Revenue Agency replied that, even if the three conditions are not all satisfied, this does not exclude the possibility that the carried interest may still qualify as financial income.

In situations like this, said the Revenue Agency, it is necessary to analyze the proceeds on a case-by-case basis, in order to determine whether they actually reflect the individual's assumption of the investment risks or whether, instead, they represent compensation for work and therefore qualify as employment income.

In Tax Ruling no. 407, the Revenue Agency argued that the purpose of the carried interest was essentially to top up the individual's ordinary compensation, and that it therefore qualified as employment income under article 51 of the Italian Income Tax Code.

The Revenue Agency argued that the size of the investment made by the managers was insufficient to ensure that their interests and risks were aligned with those of the other investors: a necessary pre-condition for defining the carried interest as financial income.

The Revenue Agency also cited the following circumstances as further grounds for treating the carried interest as employment income.

The fact that the managers' entire remuneration was fixed and did not include a variable portion.

The fact that, according to the remuneration policies of the asset management company that would pay it, the carried interest was a form of incentive designed to replace the variable portion of remuneration that is typically performance-based.

The fact that the investment fund regulations gave investors whose employment relationship with the asset management company had ended the right, if they were 'good leavers', to receive an amount of carried interest prorated to the date of their departure.

Instead, in Tax Ruling no. 435 the Revenue Agency treated the carried interest as financial income, on the following grounds.

The amount of investments made by the managers, even though it did not reach 1 percent of the overall investment made by the fund, was still significant in absolute terms.

The holders of the carried-interest rights would continue to bear the investment risk even if they left the company.

The right to carried interest was not reserved for investment fund personnel only; it was also granted to third-party investors, thus ensuring alignment between the interests and investment risks of the managers and those of the other investors.

Tax Ruling no. 436

In this case the Revenue Agency was asked to shed light on how to calculate the overall amount invested by the managers, should the investment giving rise to the carried interest be made in several tranches and be in company shares.

The applicant, indicating that there would be a special appraisal to determine the fair market value of the company, asked whether the value of the investments made by the managers before the appraisal should be based on their actual original cash outlay or whether, instead, it should be based on the current fair market value of the company shares.

The Revenue Agency, citing (among other things) Circular no. 25/E of 16 October 2017, stated that the investment should be quantified in the following way. It was necessary:

— first, to consider all the financial instruments subscribed for by the managers and employees: both those carrying rights to carried interest and those not carrying such rights;

— second, to determine the actual value of the equity, based on the fair market value identified in the appraisal;

— finally, to ascertain whether the actual cash outlay of the managers was equal to or higher/lower than 1 percent of the company's equity.

With specific reference to the question submitted by the applicant, the Revenue Agency stressed that, based on the literal wording of article 60(1)(a) of Decree Law no. 50, according to which the overall investment by the managers must involve an "*actual outlay equal to at least 1% (…) of the equity in the case of a company*", reference should be made to the monetary value of the investment made by the managers and not to its current fair market value.

Contatti

Studio Associato - Consulenza legale e tributaria

Antonio Deidda
Partner
Family Office and Private Client
E: adeidda@kpmg.it
T: +39 02 6764 4762

Tomaso de Simone
Partner
Family Office and Private Client
E: tdesimone@kpmg.it
T: +39 06 8096 3552

kpmg.com/it

kpmg.com/it/socialmedia

kpmg.com/app

Download on the App Store

Family Office and Private Client News / 10 November 2020