Italy: Recent clarifications regarding M&A transactions

Tax Alert

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Participation exemption: relevance of the start-up phase

Under the participation exemption regime, 95 percent of capital gains earned by a resident company from the transfer of equity interests are tax-exempt if all the following conditions are met.

i. The seller has held the shares uninterruptedly for 12 months before their transfer.

ii. The shares are booked under fixed assets in the first financial statements approved after their purchase.

iii. The shares are in a company which, from the start of the third year before their transfer, has engaged in active business (excluding real estate business) and has been resident in a cooperative jurisdiction.

The Italian Revenue Agency, in a recent tax ruling(1), has described the conditions under which a start-up phase may be deemed as active business for the purposes of point (iii)(2).

Citing a former statement of practice(3), the Italian Revenue Agency has clarified that - when followed by an active business - preliminary and auxiliary activities carried on during the start-up phase may be included in the computation of the three years preceding the transfer. Therefore, the active business requirement can be met during the start-up phase if the company, after completing the preparatory phases and setting up an autonomous organizational apparatus, begins to carry out the activity for which it has been established.

The start-up phase typically includes preparatory studies, applications for permits, licenses and authorizations, market research, initial training of personnel, and acquisition of the financial and technical resources necessary to start the business.

The case considered in the tax ruling involved a subsidiary which, in 2015, had begun to obtain authorizations and prepare technical documents necessary for an active business, which started in 2016. Even though such activity could, by its nature, be included in the start-up phase, the tax authorities concluded that the active business condition was met since 2016 as there was no documentation showing that it had started at the beginning of 2015. Therefore, they ruled that the parent could benefit from the participation exemption from 2019.

(1) Ruling no. 2 of 14 September 2018.
(2) Since 1 September 2018, replies to ruling applications have been published in a specific section of the Italian Revenue Agency's website.
(3) Notice no. 7 of 2013.

Contributions, demergers and abuse of law

Under the Italian general anti avoidance rule, also known as the 'abuse of law rule', a transaction is abusive, for both direct and indirect tax purposes, and can be disallowed by the tax authorities, with the application of administrative sanctions (but no criminal penalties), when all the following factors are in play.

i. The transaction (or series of interconnected transactions) has no economic substance, i.e. though valid on paper, it is an inappropriate way of achieving the stated business goal.

ii. An undue tax advantage is obtained, by obstructing the purpose of a tax rule or principle, even without formally breaking any tax rule.

iii. The tax advantage is the essential effect of the transaction.

Transactions cannot be defined as abusive if they are justified by sound business reasons, including shake-ups or management decisions to improve the structure or operations of a business or professional activity. It is up to the Italian Revenue Agency to prove that a transaction is abusive, while the taxpayer has to demonstrate that there is a non-marginal and sound business purpose. The concept of abuse of law applies only when a transaction cannot be assessed under a specific anti-avoidance measure. The taxpayer may submit a ruling application to the tax authorities, in order to understand whether a transaction may fall within the scope of the abuse of law rule.

This month, the Italian Revenue Agency published on its website three statements of practice, in the form of tax rulings, regarding the application of the abuse of law rule to a) two demergers and b) a contribution followed by a demerger.

Demerger aimed at separating real estate from commercial business

Under Italian tax law, demergers are tax-neutral for income tax purposes.

The Italian Revenue Agency used to challenge demergers, especially when the shareholders of the demerging entity subsequently transferred the shares they had received. These challenges were based on the former 'wide-scope' anti-avoidance provision, which contained a list of suspicious transactions, including demergers. More specifically, challenges were based on the deemed circumvention of the tax rule on taxable transfers of assets (or going concerns), on the absence of sound business reasons, and on the achievement of undue tax advantages (see our Tax Alert of 1 August 2017).

In a recent tax ruling, the Italian Revenue Agency[4] has clarified that a partial and proportional demerger, which results in the transfer of a real estate business from one company to another existing company, having the same four individual resident shareholders as the first one, is not abusive. In this case, tax neutrality is not an undue tax advantage as, after the transfer, the assets remain under the business enterprise regime and any deemed capital gain will be subject to tax when they are sold.

(4) Ruling no. 21 of 3 October 2018

Moreover, a demerger is the most natural and appropriate way to separate commercial from real estate business, in order to develop both and diversify risks. The transaction is not abusive for registration tax purposes either, and is subject to the standard fixed amount (currently, EUR200).

The Italian Revenue Agency has also reached the same conclusion[5] with respect to a non-proportional demerger, designed to assign a residential property, belonging to a company owned by four shareholders, to four newly set up enterprises, each owned by one of the same four individuals. The business goal of the demerger was to enable each shareholder to manage the real estate business independently of the other three and thus avoid conflicts between the four.

Contribution of shares followed by a demerger

In reply to a ruling application submitted by a company owned by four individuals, the Italian Revenue Agency has clarified[6] that a contribution of shares followed by a demerger of the beneficiary is an abusive transaction.

Facts presented in the tax ruling application

Four brothers each own a 25 percent equity interest in company (A). They intended to transfer these interests to a newly set up company (A1), through a contribution, so that Company A1 would own 100 percent of Company A. Subsequently, parts of Company A1 would be hived off to three NewCos (A2, A3 and A4). As a result of this demerger, each of the four entities (A1, A2, A3 and A4) would be 100 percent owned by one of the four individuals. In the end, four new holding companies, 100 percent owned by each individual, would own 25 percent of the equity in Company A.

The stated goal of this transaction was to split the business between the four individuals and enable each one (and his family members) to manage his own company independently.

The contribution was intended to be tax-neutral, as per article 177 (2) of the Italian Income Tax Code (IITC)[7]. The subsequent demerger would be tax-neutral too, as per article 173 of the IITC.

Company A submitted a tax ruling application to the tax authorities in order to ascertain whether the reorganization might be considered abusive.

The Italian Revenue Agency's reply

The Italian Revenue Agency clarified that a contribution followed by a demerger would trigger the abuse of law rule because:

— it would be devoid of economic substance, as it would produce no effect other than a tax advantage;

— it would involve an excessive number of transactions, which could be avoided by following normal market logic;

(5) Ruling no. 36 of 12 October 2018

(6) Ruling no. 30 of 8 October 2018.

(7) According to which, in a contribution where the recipient acquires, integrates or increases a controlling equity interest in another company, the value of the shares received in exchange by the contributor is deemed equal to the increase in the recipient's net equity as a result of the contribution. Therefore, if the recipient increases its net equity by an amount equal to the tax basis of the contributed shares prior to the contribution, no taxable gain will arise for the contributor.

— it would not be supported by non-marginal and sound business reasons, as the stated business goal - i.e. creating four new holdings, each one fully owned by one of the four brothers - could be achieved through four contributions, made by the four individuals to four new companies (however, this different and more logical transaction would give rise to a gain taxable to each individual);

— an undue tax advantage (i.e. tax neutrality) would be obtained.

Merger leveraged buyout and abuse of law

In a recent judgment[8], the Supreme Court decided that a merger leveraged buyout (MLBO) is not abusive.

An MLBO is a complex transaction whereby one company (usually a special purpose vehicle) purchases another (the target) and subsequently merges with it. The purchase is financed with debt and the net assets of the target serve, after the merger, as a guarantee for the repayment of the debt.

This procedure is allowed and governed by the Civil Code. From a tax perspective, it is a tax-neutral transaction; however, it has always been scrutinized by the tax authorities, especially under the former 'wide-scope' anti-avoidance provision, which contained a list of suspicious transactions, including mergers. In the past, the tax authorities often disallowed the advantages of this type of group reorganization, in terms of deduction of interest expenses by the company resulting from the merger.

The case that came before the Supreme Court concerned an Italian subgroup owned by a US-resident parent. One of the Italian subsidiaries purchased two Italian companies, which, soon after, were sold to another Italian group company, newly set up and dormant. The two purchased companies, 100 percent controlled by the dormant company, were then merged into it. The merger deficit, which is the difference between the 100 percent equity interest and (higher) purchase price, was allocated to goodwill. Under the regime in force at the time, the company resulting from the merger could deduct (besides the interest on debt used to finance the acquisition) the amortization of goodwill over ten years.

(8) Supreme Court judgment no. 21824 of 7 September 2018.

The tax authorities challenged this reorganization, on the grounds of the general anti-tax avoidance rule in force at the time, arguing that:

— there were no sound business reasons for the MLBO, which was only designed to obtain a tax advantage, i.e. the deduction of higher amortization of goodwill;

— the business reasons stated by the group (i.e. the MLBO was meant to reduce the number of group companies) appeared to be in contrast with the setting up of a new Italian entity the same year;

— the group could have achieved the same business goal by merging the two entities into another existing and active company, though realizing lower goodwill, while the dormant company could have been liquidated; therefore, the group adopted this scheme with the sole purpose of obtaining higher deductible goodwill.

The appeal court agreed with the tax authorities that the MLBO generated an undue tax advantage and was aimed at circumventing the rule that disallows deduction of the (positive) difference between the purchase price of shares in controlled companies and the corresponding net asset value.

The Italian group appealed against this decision and the Supreme Court ruled in favor of the taxpayer, arguing that it had adequately proved that the features and goals of the transaction were those typical of an MLBO.

Final remarks

This judgment is in line with other recent case law and statements of practice issued by the tax authorities. For instance, in a recent official interpretation[9], the Italian Revenue Agency clarified that if an MLBO follows the procedures laid down by the Civil Code (e.g. the merger plan must show that the debt is financially sustainable) it cannot be deemed abusive. Therefore, interest paid by the company resulting from the merger must be considered business-relevant and deductible in accordance with the general rules on interest deduction by corporates.

(9) Notice no. 6 of 30 March 2016.

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