



Italy: Taxation of carried interest

Tax Alert
20 November 2017



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This year has seen the introduction of measures⁽¹⁾ to define the Italian taxation of carried interest, representing a remuneration form attributed to managers and employees holders of shares, quotas or financial instruments with 'strengthened' economic rights. Such investments can also be indirect, as the explanatory report accompanying the new measures specifies that securities can also be held through a special purpose vehicle.

Carried interest is granted to managers and employees of investment companies and private equity firms in order to align their interests with those of other investors (the additional income depends on the performance of the investment companies and private equity firms).

More specifically, carried interest arises when:

- the individual receives a profit that is more than proportional to the quantity of shares held;
- the individual has the possibility of converting the special shares into a more than proportional number of ordinary shares.

Requirements

If the following requirements are met, the new tax rule treats carried interest as **capital income** rather than **employment income**.

- All the individuals who have a carried interest must have invested, in aggregate, at least 1 percent of the total amount invested by the company;
- Income from the securities carrying the special profit rights must accrue only after all the other investors have obtained a minimum pre-defined return on their capital investment.
- The securities must be held by the individuals (or, in the event of their death, by their heirs) for a minimum of 5 years. This holding period can be shorter than 5 years if another firm takes over the companies in which the individual's employer has invested or if the funds in which the employer has invested are transferred to a new fund manager.

(1) Article 60 of Law Decree no. 50 of 24 April 2017, converted into law on 21 June 2017.

Benefits

If all the requirements are met, carried interest can be taxed as **capital income** at a flat rate of 26 percent rather than as **employment income** at a progressive tax rate of up to 43% (plus regional tax, municipal tax and social security contributions).

Tax Office Circular no. 25/E of 16 October 2017

This circular confirms that carried interest will certainly be treated as capital income if the above requirements are met. But even if they are not, the taxation of carried interest as capital income should not be excluded. A case-by-case analysis is necessary in order to understand whether carried interest should be treated as capital income or employment income. For example, the following factors indicate that carried interest can be treated as capital income:

- The requirement of 1 percent is not met but the individuals have taken on the risk of losing all the capital they have invested (this is a very important indicator).
- There are special agreements between the individuals and the employer, establishing that the individuals may keep the financial instruments after their employment contract has terminated.

On the other hand, a clause that limits the potential investment loss is a sign that carried interest is more akin to employment income. Likewise, if the individual's salary is lower than the standard salary paid for similar employment contracts, this suggests that the carried interest is part of the individual's employment income.

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Tax Alert / KPMG in Italy / 20 November 2017

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