



# Leveraged Buyouts Circular letter

**Tax Alert**  
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On March 30<sup>th</sup>, the Italian Tax Authority ('ITA') has provided some clarifications on the tax treatment of leveraged buyouts ('LBOs') via a Circular Letter ('the Circular').

Key messages from the ITA are:

- (i) the LBO is not generally a tax abusive transaction; therefore, the related interest expenses are deductible, under the ordinary earning stripping rules
- (ii) emphasis on the substance and activity of foreign inbound investment platforms or holdings, which is essential to a tax efficient exit
- (iii) look through approach on withholding tax on interest and dividends.

## 1. Background

The Italian Civil Law explicitly regulates the LBO, but no special tax rules are applicable to this topic. Over the last decade, ITA has frequently challenged this kind of transactions, supporting its claims mainly via the following arguments:

- Abuse of law;
- Lack of business purpose for the interest incurred by the BidCo; and
- Application of transfer pricing rules between BidCo and its non-Italian Parent.

## 2. Interest deductibility

According to the Circular, interest expenses incurred by an Italian BidCo on loans obtained to fund the LBO should be considered, in principle, as having business purpose and therefore tax deductible. Abusive transactions are still subject to tax authority reviews.

## 3. Other fees deductibility

Management fees and other similar expenses paid by the BidCo / Target to private equity sponsors are deductible only to the extent they have a business purpose.

#### 4. IBLOR loans treatment

According to the Circular, in order to understand the correct withholding tax ('WHT') treatment on interest on IBLOR (Italian Bank Lender of Record, lending structures where an Italian bank grants loans backed up by foreign credit support providers) loans, a look-through approach should be used.

The Circular also confirms that, following the 2016 Direct Investment Decree, no WHT is due on interest paid to certain qualified foreign investors.

#### 5. Shareholder loans

Shareholder loans granted in the context of a LBO can be recast as equity based on a substance over form approach. Typical subordination, maturity and rating terms should be considered in that respect.

#### 6. Artificial structures

The Circular emphasizes that 'substance' is essential to obtain Treaty Benefits and/or access to EU Directives on exit. A foreign resident holding company can be respected as such only to the extent it is a 'genuine set up' and not 'artificial structures'.

A structure would be artificial in case:

- It does not have sufficient 'substance'. Substance indicators are the availability of directors and/or staff with adequate skills, not provided by third party advisory organizations and the real involvement of the Holding company in decision making process related to its investments;
- It is a conduit structure.

An artificial structure would be denied Treaty Benefits and would be subject to the general anti abuse rules provided by EU Parent Subsidiary Directive.

The Circular indicates that in case a Foreign Holding company is disregarded for Treaty purposes, it should be possible to apply to its shareholders the same Double Tax Treaty Regime that would be applicable had they invested directly.

#### 7. Effects of the Circular

The Circular addresses important issues and confirms the deductibility of interest costs on acquisition financing.

At the same time, it focuses on the tax treatment of the exit from Italian investment placing emphasis on foreign investors' substance. It can therefore be anticipated an increased focus of the Tax Authorities on scrutinizing the tax treatment of the exit from Italian investments.

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## Contatti

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