Newsletter

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Circular Letter of the Italian Revenue Agency No. 25/E of 16 October 2017: income from participation in companies, entities and undertakings for collective investments held by managers and employees ("carried interest")

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Introduction

Article 60 of the Law Decree No. 50/2017 (the "**Decree**") provides for the tax regime applicable to the income from participation in companies, entities or undertakings for collective investments (*Organismi di Investimento Collettivo del Risparmio* - "**OICR**") giving rise to enhanced economic rights, held by managers and employees ("carried interest"). In particular, such provision sets out the requirements for its qualification, for tax purposes, as financial income (income from capital or other income).

Following concerns expressed by operators and associations in the venture capital and private equity sectors, the Italian Revenue Agency issued Circular Letter No. 25/E of 16 October 2017 (the "**Circular Letter**") clarifying the scope of the tax provision relating to carried interest, and in particular the following requirements for its application:

(i) the minimum investment;
(ii) the deferral in the distribution of the income;
(iii) the minimum holding period for the participation.

The Circular Letter also provides general clarifications of the application of the tax provision relevant for co-investment plans for employees and managers both in the private equity sector and in other sectors.

This newsletter focuses on the clarifications provided in the Circular Letter. For an analysis of Article 60 of the Decree No. 50/2017 please see our Newsletter No. 1 of 2017.

Scope of application

Article 60 of the Decree is applicable to employees and managers of companies, entities, or OICR, as well as to employees and managers of other entities having a direct or indirect relationship of control or management of such companies, entities or OICR.

The Circular Letter clarified that managers and employees of advisory companies also fall under the scope of Article 60 of the Decree. By focusing on investment strategies and their choices, these latter parties provide management support and, therefore, integrate the "indirect" relationship provided by the tax provision.

Accordingly, Article 60 of the Decree applies to managers and employees of both SGR and advisory companies as well as companies that make investments and target companies.

On the other hand, professionals (*e.g.* attorneys and chartered accountants) acting as consultants are not included in the scope of application of Article 60 of the Decree.

From an objective point of view, the Circular Letter clarified the meaning of "enhanced economic rights", *i.e.* "carried interest". According to the Revenue Agency, the economic rights to which the tax provision refers are the rights to receive profits more than proportionally to the investment made, after the repayment of the capital and the payment of the relevant minimum yield to shareholders (*i.e.* hurdle rate).

As a final remark, considering the broad wording of the tax rule, the latter should be applicable also to similar instruments issued in sectors other than the financial sector (*e.g.* the industrial sector).

Requirements

(i) Minimum investment

The rule requires that the overall investment commitment of managers and employees must constitute an effective investment of at least 1% of the overall investment made by the OICR or of the net equity of the company.

The Circular Letter provided the following clarifications where managers and employees hold OICR units.

- The basis for the calculation of managers' minimum investment is the overall investments made by the OICR, both for direct and indirect participation in the OICR. The latter occurs when the units of the OICR are held by investment management companies, companies delegated to the management, companies or other entities (*e.g.* trusts or foundations) directly or indirectly related to the managers.

- The value of the overall investment made by the OICR, including management fees, is equal to the capital committed and called up, net of the indebtedness undertaken by the OICR for the purposes of the investment.

- The minimum investment threshold should be verified at the moment that subscriptions are made, *i.e.* at the time of the commitment to the investment. However, if the called-up capital is less than the commitment, the threshold of 1% is adjusted to take into consideration the lower investment carried out by the OICR. As a result, the requirement of the minimum investment is deemed to be met if managers' effective investment is equal to 1% of the investments made by the OICR.

- Once the threshold of 1% has been met, the events after the termination of the subscription phase, like inheritance of persons not qualifying as managers or employees or the exit of the manager, do not imply the loss of the requirement for the other managers or employees.

- For the purposes of calculating the minimum investment threshold, financial instruments with enhanced economic rights subscribed to by persons other than managers, (*e.g.* other shareholders or sponsors, including investment management companies not participated by managers), are not relevant.

- Where there is an acquisition of financial instruments through loans granted to managers, the requirement of the effective investment is not met if such loans exclude, for the whole or in part, the refund of the capital in the event of renouncement of the credit by the creditor or if other events occur. Indeed, in such case, the manager would not bear any risk of loss of the invested capital. On the contrary, financial instruments acquired by managers or employees through loans at below-market rates are relevant for the calculation of the 1% threshold, without prejudice to the fact that such loans are relevant for the determination of employment income pursuant to Article 51(4)(b) of Presidential Decree No. 917/1986.

According to the Circular Letter, considerations made with regard to investments in OICR are also applicable to financial instruments for participation into companies, with the following additional clarifications.

- The net equity's value is determined at fair value on the basis of appropriate appraisals, also by taking into account the managers' investment.

- The required minimum investment is to be verified at the time of the subscription for the financial instruments where there is a capital increase or at the time of their acquisition.

- Where there is subscription or acquisition of financial instruments by third-party investors at a later date, managers are required to adjust their investments in order to reach the threshold of 1% of the new net equity's value before the end of the financial year during which the third-party investors have made the investment.

(ii) Deferral in the distribution

The Circular Letter pointed out that deferral in the distribution requirement relates exclusively to the extra-return, *i.e.* the carried interest. On the contrary, such a requirement does not apply to the capital refund or the minimum yield, (*i.e.* hurdle rate), for which managers holding financial instruments with enhanced economic rights are treated like other investors.

In relation to the disposal of the investment, Article 60 of the Decree provides that the disposal of financial instruments with enhanced economic rights generate financial income if, where there is a change of control, other shareholders or participants realized a consideration at least equal to the invested capital and to the minimum yield. As clarified by the Circular Letter, this presumption does not apply when there is no change of control.

(iii) Minimum holding period

The Circular Letter clarifies that the five-year minimum holding period requirement for financial instruments with enhanced economic rights, applies also to financial instruments – that do not have enhanced economic rights - that are included in the calculation of the minimum investment threshold. Therefore, the disposal of such financial instruments implies the disapplication of the presumption of the qualification of the carried interest as financial income.

Moreover, the Circular Letter underlines that the holding period starts from the date of each subscription. Therefore, where a manager is substituted by a new one, the new manager is not allowed to carry forward the holding period of the previous manager.

Finally, the minimum holding period requirement does not prevent the holder from receiving the carried interest before the five-year period. Therefore, carried interest distributed before the five-year period may be qualified as financial income and may be subject to the relevant tax regime. However, according to the Circular Letter, if these instruments are disposed of before the expiration of the five-year period, the related income is to be re-qualified as employment income and the manager is required to pay the additional tax due, if any.

Final considerations

If the requirements in Article 60 of the Decree are not met, the Revenue Agency has specified that the qualification for tax purposes of the related income will be evaluated on a case-by-case basis.

In particular, the financial nature of the income may be inferred basing on the following criteria:

- the investment allows, also from a quantitative perspective, to align investors and managers with respect to interests and to exposure of the risk of losing the invested capital*;*

- the manager has the right to maintain the holding of the financial instruments despite termination of the employment relationship, thus excluding the existence of a link with the employment activity of the manager. On the contrary, good or bad "leavership provisions" are indicators of a link between the income and employment activity carried out by the manager, implying the qualification of the income as employment income;

- the manager bears the risk of losing the invested capital;

- the manager is remunerated properly for their employment activity, so that the carried interest is not deemed to be a bonus that integrates with ordinary remuneration.

Any taxpayer wanting to have more certainty on the tax treatment of income deriving from financial instruments with enhanced economic rights, may submit an application for a ruling to the Italian Tax Authorities.

In relation to the timing of the application of the tax provision, the Circular Letter clarified that the presumption of qualification for tax purposes is applicable, if the requirements are met, to income received starting from the entry into force of the Decree, *i.e.* from 24th of April 2017 (according to the "cash principle"), even if it derives from financial instruments subscribed to before such date. Conversely, the qualification of income received before such date, even if the requirements are met, is to be evaluated on a case-by-case basis in light of the criteria mentioned above.

For any further clarification feel free to contact our Tax Department at tax@chiomenti.net