

Newsletter

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The new tax regime applicable to investments made by managers and employees through the grant of enhanced economic rights (i.e., carried interest)

Introduction

Following the publication of Law-Decree No. 50 dated 24 April 2017 (**Law Decree No. 50/2017**), certain new provisions have been enacted as an amendment to the Budget Law for 2017.

Law-Decree No. 50/2017 includes significant tax provisions, such as Article 60 which sets out the tax regime applicable to the income from shareholdings, interests or other financial instruments, issued by companies, entities or undertakings for collective investments in transferable securities (“**UCITS**”) giving rise to enhanced economic rights (e.g. carried interest), that are held by managers and employees. Article 60 states that the income connected to such enhanced economic rights must qualify as financial income, provided that certain requirements are met.

Article 60 is particularly relevant for participants in the private equity industry and for investment funds managers, who are often involved in mid- and long-term co-investments. If the requirements of Article 60 are met, the risk that income from such investments will be qualified as income from employment or self-employment is removed.

The requirements for an investment to qualify as financial income

Article 60 of Law-Decree No. 50/2017 designates as financial income (either as income from capital or other income) income derived from direct or indirect shareholdings,

interests or other financial instruments issued by companies, entities or UCITS¹, realized by managers or employees of:

- such companies, entities and UCITS; or
- entities that are controlled or managed by such companies, entities and UCITS,

to the extent that the shareholdings, interests or financial instruments give rise to enhanced economic rights².

In order for the income to qualify as financial income, the following requirements must also be met:

- a) the overall investment commitment of the employees and managers holding the relevant shareholdings, interests or financial instruments giving rise to enhanced economic rights must constitute an effective investment of at least 1%³⁻⁴ of the net equity of the issuer company or of the overall investment made by the UCITS;
- b) the income connected to the enhanced economic rights must accrue after all shareholders or unit-holders have obtained: (i) a return equal to the invested capital plus a minimum yield as provided in the bylaws or regulations of the investment (*i.e.*, hurdle-rate); or (ii) a sale price equal to at least the invested capital plus such minimum yield, where there has been a change of control in the relevant companies, entities or UCITS;
- c) the relevant shareholdings, interests or other financial instruments giving rise to enhanced economic rights must be held by managers and employees for at least five years or until a change of control or a change of management occurs in the relevant companies, entities or UCITS.

The above requirements are aimed at guaranteeing that carried interest and other similar bonus plans align the goals and the risks of managers with those of investors.

If the above requirements are not met, the income from carried interest qualifies as income from employment or self-employment. In this respect, the explanatory notes to Law-Decree No. 50/2017 clarify that Article 60 aims at providing a bright-line rule on the tax treatment applicable to this kind of income and at preventing abusive conduct where income from employment or self-employment is converted into financial income.

The new regime enacted by Article 60 is applicable to companies, entities or UCITS which are resident in Italy or in Countries that allow for an adequate exchange of tax information.

¹ Under Article 1(1)(k) of Legislative Decree No. 58, dated February 24, 1998, an Undertaking for Collective Investment in Transferable Securities (UCITS) is a "body set up in order to provide the service of the collective management of assets, the capital of which is obtained from multiple investors through the issuance and offer of units or shares, managed upstream in the investors' interests and independently by the same and also invested in financial instruments, credit, including credit backed, in favor of subjects other than consumers, by the UCITS capital, equity or other fixed or non-fixed assets, based upon a predetermined investment policy".

² Enhanced economic rights are generally embedded into particular categories of financial instruments which grant to their holders financial returns which exceed the proportion of ordinary shareholdings or interests in the hands of other investors, normally in exchange for limited administrative rights (e.g. no voting rights) and/or restrictions on the change of ownership and/or deferment in the right of realizing the income.

³ Article 60(2) of Law-Decree No. 50/2017 states that any amount that is taxed as income from employment (or self-employment) should also be taken into account for the determination of the overall investment commitment when shareholdings or interests are granted in-kind to managers and employees. For non-resident managers and employees, any amount that would have been taxed in their hands if they had been subject to Italian taxation should be considered in relation to this.

⁴ Article 60(3) of Law-Decree No. 50/2017 specifies that the amount invested in shareholdings or interests without enhanced economic rights should also be taken into account when determining the overall investment.

Also, Article 60 operates in addition to the tax regime applicable to the grant in kind of shareholdings, interests or financial instruments in favor of managers and/or employees. Such grants are, in principle, deemed to be treated as income from employment or self-employment.

Final remarks

Article 60 of Law-Decree No. 50/2017 introduces a welcome clarification in a tax area that has been critical in the last few years, especially for participants in the private equity industry.

On a further note, the benefits of this new regime operate at two different levels. Firstly in relation to the reduced tax burden in the hands of managers and employees, if the requirements above are met, and second in providing certainty to withholding agents (*i.e.*, the paying entities who grant the enhanced economic rights), thus incentivizing mid- and long-term co-investments by managers and employees.

However, from a practical point of view, the new regime raises some issues. For instance, there is uncertainty as to the date by which the requirement of the overall investment commitment by managers and employees should be met and regarding the consequences for the withholding agent where the minimum holding period of five years is not fulfilled yet.

In relation to entry into force of the tax regime, Article 60 of Law-Decree No. 50/2017 expressly provides for that the new regime is applicable to income realized from 24 April 2017, *i.e.*, earned on a cash basis.

Accordingly, it is advisable to review investment plans that are currently in force to evaluate the applicability of the new regime.

Finally, the provisions of Law-Decree No. 50/2017 are subject to conversion into Law within 60 days after their publication in the Official Gazette. It is possible that amendments can be made to Article 60 upon conversion into law of Law-Decree No. 50/2017, hopefully to clarify some of the above mentioned uncertainties.

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