JONES DAY

COMMENTARY

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Italy Addresses "Carried Interest" Tax Treatment

IN SHORT

The Situation: Law Decree no. 50, recently enacted by the Italian government, introduces a number of tax measures designed to attract new investments in Italy.

The Result: Notably, Decree 50 implements rules for the tax treatment of "carried interest."

Looking Ahead: While the new provisions are welcomed by the investment community, a number of issues remain unclear.

The Italian government has enacted Law Decree no. 50 ("Decree 50"), providing a set of new tax measures aimed at, among other things, attracting investments in Italy. Decree 50 was finally approved by the Italian Parliament on June 15, 2017.

Decree 50 introduces, for the first time in Italy, rules dealing with the taxation of the income from the so-called "carried interest."

How is Carried Interest Taxed?

From a tax perspective carried interest raises two issues which were addressed by Ruling no. 103/E of December 4, 2012.

- What should be the tax treatment of the difference, if any, between the value of the investment instruments given to the managers, and the money actually paid for them?
- How should the proceeds (dividends/capital gains) derived from holding the investment instruments be treated?

On the first point, generally any such difference was to be treated as employment or self-employment income and taxed at progressive personal income tax rates (up to 43 percent).

On the second point, it was unclear whether the income deriving from the holding of the investment instruments had to be treated as employment/self-employment income or as financial income, generally subject to a 26 percent flat tax. In this respect, Ruling no. 103/E took the position that such income were to be treated as financial income unless it is linked to the continuous employment/self-employment relationship between the individual beneficiary and the issuer.

New Tax Rules Introduced by Decree 50

Decree 50 implicitly confirmed that any difference between the value of the investment instruments granted to the managers and the money paid by them should be taxed as employment income and/or self-employment income.

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On the tax treatment of the proceeds derived from the investment instruments, Decree 50 has followed the interpretation given by the Italian Tax Authorities—that under certain circumstances, the proceeds qualify as financial income. However, as opposed to Ruling no. 103/E, Decree 50 provides that the financial income tax regime is available subject to more stringent conditions.

In particular, proceeds derived from the direct or indirect holding of investment instruments by "Eligible Beneficiaries"—an entity's investment managers, advisors, or similar professionals—are treated as financial income for tax purposes under the following conditions:

- The investment instruments must relate to companies, entities, and/or undertakings resident or set up in Italy, or in a country that allows an adequate exchange of information with Italy (collectively referred to as the "Eligible Securities");
- The actual overall investment commitment of the Eligible Beneficiaries must be at least equal to 1 percent of, respectively: (i) the net equity of the issuer company or entity or (ii) the overall investment made by the undertaking. Such investment is determined by certain, pre-defined criteria;
- The proceeds deriving from Eligible Securities must accrue only after all the shareholders, unit holders, or investors have obtained a return equal to the invested capital plus a minimum yield; and
- The Eligible Securities must be held by the Eligible Beneficiaries or, in case of death of the Eligible Beneficiaries, by their heirs, for at least five years, or if earlier than this five-year period, until the occurrence of a change of control or a change of the management company of the undertaking.

In a nutshell, after the entry into force of Decree 50, carried interest meeting the above conditions should always give rise to financial income and not to employment/self-employment income. It should generally be subject to the 26 percent flat tax instead of the ordinary progressive tax rates.

Open Issues

Even after the enactment of Decree 50, some issues still remain unclear.

First, what would happen if the above conditions are not met? A simple answer could be that income generated by carried interest mechanisms should be treated as employment/self-employment income. The Report accompanying Decree 50 states, however, that "absent such requirements, the proceeds … shall be treated as labor income (employment, assimilated to employment or self-employment income) or financial income depending on the circumstances." This statement seems to imply that, in the absence of the conditions set forth in Decree 50, the analysis on the tax treatment of the income derived from the financial instruments may still vary depending on circumstances.

In addition, although Decree 50 does not expressly deal with the tax treatment of income derived from investment instruments other than the Eligible Securities granted to the Eligible Beneficiaries, a question could arise if the new rules, even by way of analogy, generally may affect the tax treatment applicable to the granting of ordinary shares, stock options, or other similar employee stock benefits that do not grant preferential economic rights to employees and directors.

Absent any specific reference in the law, one should consider the new rules introduced by Decree 50 as a special regime applicable to carried interest only. Therefore, the tax treatment of any income deriving from ordinary shares, stock options, or other similar employee stock benefits should not be changed. In other words, dividends and capital gains should always qualify as financial income.

THREE KEY TAKEAWAYS

1. Italy's new tax measures were crafted to encourage investment.
2. Decree 50 holds that that under certain circumstances, proceeds derived from securities ownership qualify as financial income.
3. Still, Decree 50 leaves some questions unanswered, including the tax treatment of carried interest when the prescribed conditions are not met and the treatment of income derived from financial securities not defined as eligible for the alternative, lower rate.

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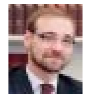

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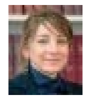

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