

THE TAXATION OF PRIVATE EQUITY IN ITALY

AIFI ITALIAN PRIVATE EQUITY AND
VENTURE CAPITAL ASSOCIATION

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1 | Introduction

The Private Equity Industry is affected, as any other industry, by taxation depending on the jurisdiction in which the investment structure will be incorporated. This brochure contains an essential description of the key Italian principles of taxation for closed-end funds and their management companies, as well as the key tax considerations in structuring the acquisition and divestment of target companies.

1.1 | Tax environment

Since 2004, the Italian taxation system has been deeply reformed in particular with respect to corporate income tax and investment vehicle rules.

Effective January 1, 2008, the Italian Parliament approved the Italian Finance Act 2008, which provides for a substantial reduction of tax rates and a modified taxable base. The Corporate Income Tax (hereinafter, “IRES”) rate has been reduced from 33% to 27.5% and the Regional Production Tax (hereinafter, “IRAP”) rate from 4.25% to 3.90%.

Other main changes concern the participation exemption regime, the interest expenses and the group taxation which were introduced with the 2004 structural reform of the corporate income tax system. Also a substitutive tax on certain corporate re-organizations has been introduced.

The main regulations resulting from 2004 and 2008 corporate income tax reforms are herein after summarised:

- the participation exemption system for capital gains on the disposal of shareholdings;
- the abolition of the thin capitalization and asset pro-rata rules and the introduction of new regulations aimed at limiting the tax deduction for borrowings;
- the domestic tax grouping rules;
- the possibility, mainly for Italian resident listed companies, of setting up a global tax consolidation system;
- the “consortium relief” by which holding companies are permitted to treat their investments in companies which they do not control as transparent for tax purposes;
- the introduction of the substitute tax on certain corporate re-organizations;
- the reduction of IRES corporate income tax rate to 27.5% and IRAP rate to 3.9%.

1.2 | Taxation system

Companies resident in Italy are taxable in Italy on their worldwide income. Partnerships, companies and entities of all types (whether or not they have legal personality) that do not have their legal or administrative office or their main corporate object within the territory of Italy are subject to Italian income tax only on their Italian-source income.

The system of direct taxation of companies relies on IRES and IRAP. These two taxes are regulated by independent set of rules and apply on a different taxable basis.

A foreign company with a branch (permanent establishment) in Italy is generally liable to tax in the same way as a company incorporated under Italian law, and is therefore subject to IRES and IRAP.

1.2.1 Corporate Income Tax – IRES

Resident companies

Income realised by resident companies, regardless of the jurisdiction in which the income is realised, is subject to IRES at a 27.5% rate. Losses realised in a fiscal year may be carried forward and offset against the profits of the successive five accounting periods. However, the losses realised in the first three accounting periods after incorporation of the company may, under certain circumstances, be carried forward indefinitely. For tax purposes, the overall profits of resident companies and of permanent establishments of foreign companies in Italy, is always considered as business income and taxed accordingly in one single basket, regardless of its source.

Business profits subject to IRES is calculated by taking the profits as shown in the statutory profit and loss account for the corresponding accounting period and making the decreasing or increasing adjustments required by the Income Tax Code (hereinafter, “ITC”). For IRES purposes, the tax on any capital gain on the sale of assets may be paid in full (or partially when the participation exemption is not applicable) in the fiscal period in which the gain is realised, at the taxpayer’s discretion, in equal instalments beginning with the accounting period in which the gain is realised and in the following four or fewer fiscal years, providing the assets have been owned for at least three years.

Anti-avoidance rules apply to “non-operating companies”, i.e. companies whose turnover do not exceed a minimum amount determined by applying different coefficients to specific categories of assets included in the balance sheet. These entities are subject to restrictions, specifically, with regard to the possibility of carrying forward the previous losses and are required to pay a minimum amount of IRES and IRAP, regardless of actual profits.

Non-resident companies

The ITC states that partnerships, companies and entities of all types, with or without legal personality and which are not resident in Italy, are subject to IRES on their aggregate Italian-source profits.

When there is no permanent establishment in Italy, tax is levied in accordance with specific provisions covering the respective categories of income (interest income, income from leasing business, royalties, capital gains, etc.).

Where the company has a permanent establishment in Italy, taxable business profits are calculated in the same way as for resident companies.

Interest expenses

Interest expenses and any similar cost are deductible in any tax period up to the amount of interest income and similar proceeds. The excess of interest expenses is deductible up to the amount corresponding to 30% of the gross operating result from the company’s proper business, not including depreciation and amortization of tangible and intangible assets and finance lease payments (see section 3.5.).

Participation exemption

Participation exemption on capital gains on share disposal (95%) and participation exemption on dividends received (95%) lower the tax planning benefit to set up and structure non-Italian holdings entities.

Participation exemption: taxation of dividends for corporate shareholders

The ITC provides for a 95% participation exemption for profits distributed by resident or non-resident companies from business profits, including those paid during the liquidation

or winding up of the company. Therefore, only 5% of the dividends distributed will be taxable (effective rate 1.375%) except for shareholdings held in foreign companies not located in a “white list” jurisdiction (a list of countries which will be identified by the Ministry of Finance). The shareholder may demonstrate however, pursuant to a ruling request, that it does not use these shareholdings to channel income to “non-white list” jurisdictions, given that income is taxed in the hands of the Italian shareholder on a look-through basis. The dividends exceeding the amount taxed under the look-through mechanism are 100% taxable.

Participation exemption: capital gains on share disposals for corporate shareholders

The ITC provides for a 95% participation exemption on gains of shareholdings (regardless of the value or the percentage owned) owned in resident and non-resident companies with or without legal personality, if the conditions set out in section 3.3 are met.

Group Taxation

The following types of tax consolidation, for the consolidation of group income, are available: (i) domestic tax consolidation; (ii) global tax consolidation; (iii) consortium relief.

Domestic Tax Consolidation

Every Italian resident company which forms part of a group is entitled to opt for national tax consolidation. Non-resident parent companies and other entities are allowed to participate in the tax consolidation provided that:

- they are resident in a country with which Italy has concluded a double taxation treaty; and
- they have a permanent establishment in Italy, through which a business activity is carried out, to which the shareholdings in the subsidiaries are attributed.

The effects of the option are as follows:

- the parent company determines a single computation for the group taxable profits and losses by way of aggregating the taxable bases of the electing entities;
- the subsidiaries are still required to prepare a return, but this is given to the parent company so that the latter may file a single return with the tax authorities, summing all of the subsidiaries’ profits and losses;
- specific provisions for interest expenses deduction (see section 3.5);
- it is no longer possible to adjust the consolidated income in respect of the taxable amount of either dividends distributed by the subsidiaries or capital gains from inter-company transfers.

Once the option for tax consolidation is made, it is irrevocable for a minimum of three accounting periods.

The group taxation rules make reference to the standard definition of control contained in the Italian Civil Code, namely both of the following conditions must be met:

- holding, directly or indirectly of a majority of the voting rights at general meetings of shareholders;
- holding of rights to participate in more than 50% of the profits of the subsidiary.

Special rules apply in case of indirect shareholdings, with respect to the dilution of control in a chain of shareholdings. For example, if company A controls 70% of company B, and B controls 60% of company C, A, holding only 42% of C, does not control and therefore cannot consolidate C.

Regardless of the shareholding held, all (100%) profits and losses of each subsidiary must be consolidated.

Tax losses are treated as follows:

- tax losses carried forward from periods prior to the entry into the tax group may only be utilized by the company which suffered the loss;
- losses suffered during periods in which the tax group option is in force may be offset against the profits of other group members and the excess carried forward by the group leader, in accordance with the normal rules on tax loss carry forwards.

Global Tax consolidation

Italian resident companies may opt to treat non-resident subsidiary companies as if they were transparent for tax purposes.

The option is available only for companies and entities:

- whose securities are negotiated on a regulated capital market;
- which are controlled by the State, or other public entities, or by individuals resident in Italy who do not control (including via related parties) other resident or non-resident companies or entities.

Only the uppermost Italian company in a chain may exercise the option. Italian parent companies which are entitled to exercise the option for global consolidation are not permitted to do so for domestic consolidation as a subsidiary.

Under the global tax consolidation, the subsidiaries' profits or losses are attributed to each shareholder proportionally to such shareholder's share in the profits, regardless of whether the profits are distributed. This differs from the domestic consolidation where all the profits and losses of the subsidiary are to be ascribed to the parent company regardless of the percentage of ownership. Unlike

the domestic consolidation the "all-in all-out" principle applies.

Where non-resident subsidiaries are held through other Italian resident companies, the intermediate holding companies must also exercise the option for domestic consolidation with the uppermost parent company.

The option may not be revoked for a period of five years (as opposed to three for the domestic tax consolidation). Any renewals apply for at least 3 fiscal years.

Consortium relief

Italian resident companies may opt to apply a transparent taxation regime to the profits and losses (as foreseen for partnerships) of other Italian resident companies in which they hold shares. The option is open to shareholders which hold at least 10% but not more than 50% of the voting rights at general meetings and the rights in profit sharing in companies which are resident in Italy or which, if not resident, are entitled to receive the distribution of profits without suffering the withholding of tax at source (e.g. dividends to qualifying parent companies resident in other EU jurisdictions).

All shareholders must satisfy the same requirements (e.g. the shareholders must be no fewer than two and no more than ten).

The option may not be exercised where:

- the subsidiary's shareholders benefit from the reduction of the IRES (27.5%) rate;
- the subsidiary exercises the option for the domestic or global tax consolidation.

If the option is exercised, profits and losses of the subsidiary are attributed to each shareholder, according to its respective

shareholdings, in the shareholders' fiscal year that includes the year-end of the subsidiary. The option is irrevocable for three annual accounting periods (of the subsidiary).

Dividends paid by one company to another company that is within the tax transparency regime are 100% tax exempt.

Losses of the subsidiary arising during the "transparency" period are allocated, with certain limits, to the shareholders according to their shareholdings and are subject to the ordinary rules of the ITC, while tax losses suffered by the shareholders carried forward from periods prior to the entry into the consortium relief cannot be utilized to offset profits attributed by the subsidiaries.

1.2.2 Regional Production Tax – IRAP

Resident companies

Businesses are subject to IRAP. This tax is levied on the "net production value" deriving from the activity performed. The Finance Act 2008 introduces changes to the determination of the IRAP base and reduced the IRAP rate. The rules which provided for the determination of the IRAP base by making the increasing or decreasing adjustments for IRES purposes to the Revenue recorded in the Financial Statements have been abolished. The IRAP taxable base is therefore computed on the basis of the statutory accounts result. The IRAP rate has been reduced from 4.25% to 3.90%. Specific provisions are applicable to banks and financial companies as outlined in the next section.

Non -Resident companies

Non-resident companies are subject to IRAP only when they perform commercial activities in Italy for a period exceeding three months, in the form of a permanent establishment.

Taxable basis

The calculation of the basis for IRAP purposes is the result of the following calculation:

+ Total positive components (Value of Production)
Revenues from sales and services
Variations in stocks of work in progress, semi-finished and finished products
Variations in work in progress on commission
Increments in fixed assets as a result of internal work
Other revenues and income
- Total negative components (Cost of Production):
Costs for raw materials, subsidiary materials, consumables and goods
Costs for services
Costs for the use of property of third parties (rent/lease)
Employees and related costs
Tangible and intangible fixed assets depreciation and devaluation
Variations in stocks of raw materials, subsidiary materials, consumables and goods
Provisions for liabilities and charges
Other provisions
Sundry operating charges
+ Employees and related costs
+ Interest portion of finance lease payments
+ Not deductible provisions
+ Bad debts
+ The Municipal Tax on Buildings (ICI)

IRAP is not deductible in computing profits subject to IRES.

Below is a basic example of the computation of profits subject to IRES and IRAP:

IRES - CORPORATE INCOME TAX

Statutory Profit after taxes	1,000.00
<i>Increases in income</i>	
IRAP	91.65
Not deductible items	10.00
<i>Decreases in income</i>	80.00
IRES taxable basis	1,021.65
<i>Less – Losses carried forward</i>	15.00
Profit subject to IRES	1,006.65
IRES (27.5%)	276.83

IRAP - REGIONAL PRODUCTION TAX

+ Revenues	3,500.00
- Expenses	1,400.00
+ Employee and related costs	150.00
+ Interests and othe financial profits/ losses	100.00
= REVENUES	2,350.00
IRAP (3.9%)	91.65

2 | Taxation of Italian closed-end investment funds

2.1 | Overview

Investors that operate in the Italian private equity industry also include closed-end funds set up and managed by Italian asset management companies (*Società di Gestione del Risparmio - SGR*).

SGRs and Italian investment funds are regulated by the CFA (Consolidated Finance Act) and relevant implementation rules.

An Italian closed-end fund has no legal personality and constitutes an independent pool of assets established and managed on a collective basis by an SGR. Italian funds may be set up either in the form of open-ended or closed-end fund.

Investment funds performing private equity investment are set up in the form of closed-end funds in which the subscription and redemption of units may be exercised at certain predetermined dates.

SGRs are financial intermediaries regulated by the CFA and authorised to manage individual investment portfolios as well as collective savings under the supervision of the Bank of Italy and CONSOB. The SGR management activities include the setting up and management of both open-end and closed-end funds that invest in transferable securities or in the real estate sector.

The SGR acts on behalf of a fund in the implementation of the investment strategies and in the relationships with third parties, in accordance with fund rules and applicable law and regulations. The assets of a fund are separate for all purposes from the assets of the SGR, from those of each investor and from any other fund managed by the same SGR. Custody of the assets of the fund is entrusted to a depository bank. The depository bank carries out the instructions of the

SGR and verifies their compliance with the fund rules and law. In performing their respective functions, the SGR and the depository bank must act independently.

Participation by investors in the Fund is regulated by the fund rules as well as applicable law and regulations.

2.1.1 Taxation at fund level

General principles

Italian closed-end funds that invest in transferable securities are not subject to IRES or IRAP and are subject to a substitutive tax of 12.5% that applies on the “management result” at the year-end.

The management result subject to the substitute tax broadly corresponds to the increase in the net asset value of the fund and is determined as the difference between the net asset value calculated at the end of the year and the net asset value at the beginning of the year.

The net asset value of the fund is calculated on an accrual basis by adding all income derived from capital investments or other income and considering costs of the fund, in accordance with applicable evaluation criteria. The net asset value relevant for the substitutive tax purposes is the one shown in the Financial Statements of the fund to be prepared by the SGR pursuant to regulatory provisions.

The general rule provides that income received by closed-end funds is gross of Italian withholding taxes at source, although withholding taxes may be levied on certain residual categories of income. Income in respect of which an Italian withholding tax which has been levied at source, or tax-exempt income, are excluded from the management result of the fund on which the 12.5% substitute tax applies.

The following categories of income are not subject to any Italian withholding tax and, therefore, form part of the management result:

- capital gains on equity interests in companies and dividends distributed by companies;
- interest accrued on bank accounts if the annual average amount invested with the bank does not represent more than 5% of the average value of assets of the fund (if the limit is exceeded, interest is subject to withholding at source at a rate of 27% and is excluded from the management result);
- interest arising from Government bonds, bonds issued by Italian listed companies and banks, bonds issued by non-Italian resident companies, repo and stock lending transactions;
- proceeds arising from the participation in other foreign investment funds set-up in compliance with the EU Directives on UCITS.
- interest arising from loans granted to participating companies in connection with the acquisition of equity interests.

If at year-end the management result is a loss, this can be carried forward without time limit to subsequent periods in order to reduce the taxable basis of the fund. A tax asset equal to 12.5% of the loss may be recorded within the assets of the fund. As an alternative, the SGR may transfer the loss to other funds it manages, with effects starting from the fiscal year in which the loss is realised. In the event of the liquidation of the fund, the loss not offset by the fund or not transferred to other funds managed by the same SGR is attributed to investors in proportion to their participation in the fund.

Italian companies in which the closed-end fund owns a shareholding are in principle subject to the same tax regime that generally applies to Italian resident companies.

Cross-border investments and international double tax treaties

As part of their investment activity, Italian investment funds may invest in securities – such as shares and bonds – issued by non-Italian resident companies. In the content of cross-border investments, the possibility to benefit from tax treaty provisions plays an important role.

This issue is of extreme importance considering that taxes suffered by the fund on foreign-source income is not creditable against the Italian 12.5% substitutive tax, due to the special method of tax computation and the applicable substitutive tax regime.

Treaty access for Italian and foreign investment funds is still subject to debate, also considering that treaties executed by Italy usually do not provide for special rules concerning the applicability of treaty provisions to investment funds. Accordingly, reference must be made on a case-by-case basis to the general principles governing the application of treaty provisions and the nature of income collected by the fund.

Investment funds that own significant shareholdings

The substitutive tax on the management result may be increased from 12.5% to 27% under certain circumstances.

If a fund has less than 100 investors and owns shares that represent more than 10% of the voting rights in listed companies or 50% of the voting rights in non-listed companies, the portion of the management result corresponding to the capital gains on such shareholding is subject to a substitutive tax at the rate of 27%. However, the higher tax rate does not apply if more than 50% of the investors in the fund are represented by Italian or foreign “qualified investors” other than individuals (e.g. banks, investments companies, asset

management companies, pension funds, etc.). The asset management company must assess the number of investors as of 31 December of each year and if the conditions for the higher taxation are satisfied, the above-mentioned rule is applicable starting from the following year.

Investment funds the units of which are wholly owned by non-Italian resident “Qualifying Foreign Investors”

An Italian investment fund the units of which are wholly subscribed by “Foreign Qualifying Investors” is not subject to the 12.5% substitute tax on the management result and may be regarded as fully exempt from taxes, save for withholding taxes that may be levied at source on residual categories of income.

The definition of “Foreign Qualifying Investors” includes:

- a) non-Italian resident persons that: (i) are the beneficial owner of proceeds collected; and (ii) are resident for income tax purposes in a State that allows the exchange of information between the tax authorities (referred to as “white list” States) as identified by the Italian tax authorities;
- b) “institutional investors” that are established in a “white list” State;
- c) organisations established in accordance with international agreements ratified in Italy;
- d) central banks or organisations that manage the official reserves of foreign States.

More in particular, the definition of “institutional investor” includes all entities which, regardless of their legal status and irrespective of their tax regime in the State of residence or establishment (i.e. including both entities subject to income tax as well as those entities that are not subject to income tax), have as main activity that of managing investments on their own account or on behalf of third parties.

Two different categories of investors may in principle qualify as “institutional investors” and benefit of the exemption regime:

- a) entities that are subject to regulatory control by the competent regulatory authorities in the State of establishment (such as, for instance, insurance companies, investment funds, SICAVs, pension funds and asset management companies);
- b) other entities that are not subject to regulatory control and that are not subject to tax in their State of establishment, provided that:
 - (i) they have a specific competence and experience in financial instruments and transactions, which is declared in written form by the legal representative; and
 - (ii) the entity has not been established with the purpose of managing investments made by a limited number of investors.

The tax authorities have issued further guidance with specific respect to foreign partnerships and trusts.

A case-by-case analysis is usually necessary in order to determine whether or not a foreign person may be regarded as a “Foreign Qualifying Investor” for the purpose of ensuring the exemption at the level of the Italian fund.

Procedural requirements must be satisfied by the foreign investors, including limitations to the transferability of the units, and the information concerning the status of the investor must be made available to the SGR together with self-declaration attesting that the relevant conditions are satisfied.

Proposed reform of the tax regime of closed-ended funds

The reform of the system of taxation of closed-end funds has been thoroughly evaluated by the Italian Government and players in the past and is still under debate.

The potential reform would be focused on the attempt to align the tax regime of Italian investment funds to that applicable to foreign funds by, among other things, eliminating the 12.5% substitutive tax that applies on an accrual basis at the fund level and introducing a system of taxation in the hands of the investors on a cash basis.

2.1.2 Taxation at the investor level

Non-resident investors

Proceeds from funds the units of which are wholly owned by “Foreign Qualifying Investors”

As mentioned in the previous section, an Italian closed-end fund the units of which are wholly owned by “Foreign Qualifying Investors” is exempt from the substitutive tax on the management result.

Non-resident investors that collect proceeds from such funds are not subject to any withholding tax at source in Italy. Therefore, no taxation occurs in Italy and a substantial full tax transparency regime is granted.

Proceeds from funds the units of which are partially owned by “Foreign Qualifying Investors”

“Foreign Qualifying Investors” are entitled to the refund by the SGR of a tax credit equal to 15% of proceeds that they receive upon periodical distributions or redemption of the units.

Entitlement to the refund arises only in the case of periodical distribution of proceeds or redemption of the units by the SGR. The right to the refund does not arise in the case of sale of the units by the investor to third parties.

For the purpose of obtaining the refund of the tax credit, procedural conditions must be satisfied throughout the term of the investment, including the deposit of the units with an Italian authorised financial intermediary and submission to the SGR of a self-declaration attesting that the relevant conditions are satisfied.

The claim for the refund of the tax credit must be filed with the SGR by 31 December of the year in which proceeds are received by the “Foreign Qualifying Investor”.

Italian individual investors

Proceeds arising from the sale or redemption of the units as well as periodical distributions received by Italian individual investors that hold the units other than in connection with a business activity qualify as income from capital and are not subject to taxation.

Income from capital corresponds to the increase of the unit value deriving from the increase of the asset value at the fund level which is subject to 12.5% substitute tax at the fund level. Proceeds collected by the investor in excess of the “income from capital”, qualify as “miscellaneous income” and are in principle subject to a 12.5% substitute tax, although a different tax regime may apply depending on the status of the investor.

Italian corporate investors

Proceeds arising from the sale or redemption of the units as well as periodical distributions received by Italian resident corporate investors or commercial entities are generally subject to ordinary taxation on a cash basis.

Proceeds are included in the taxable business income subject to IRES with an entitlement to a tax credit of 15% of

proceeds received. The tax credit relates to the increase in the net asset value of the fund on which the 12.5% substitute tax applies at the fund level.

The tax credit is increased to 36.98% in the case of funds that own significant shareholdings and that have suffered the higher taxation at a rate of 27% on the portion of the management result referring to said significant shareholdings.

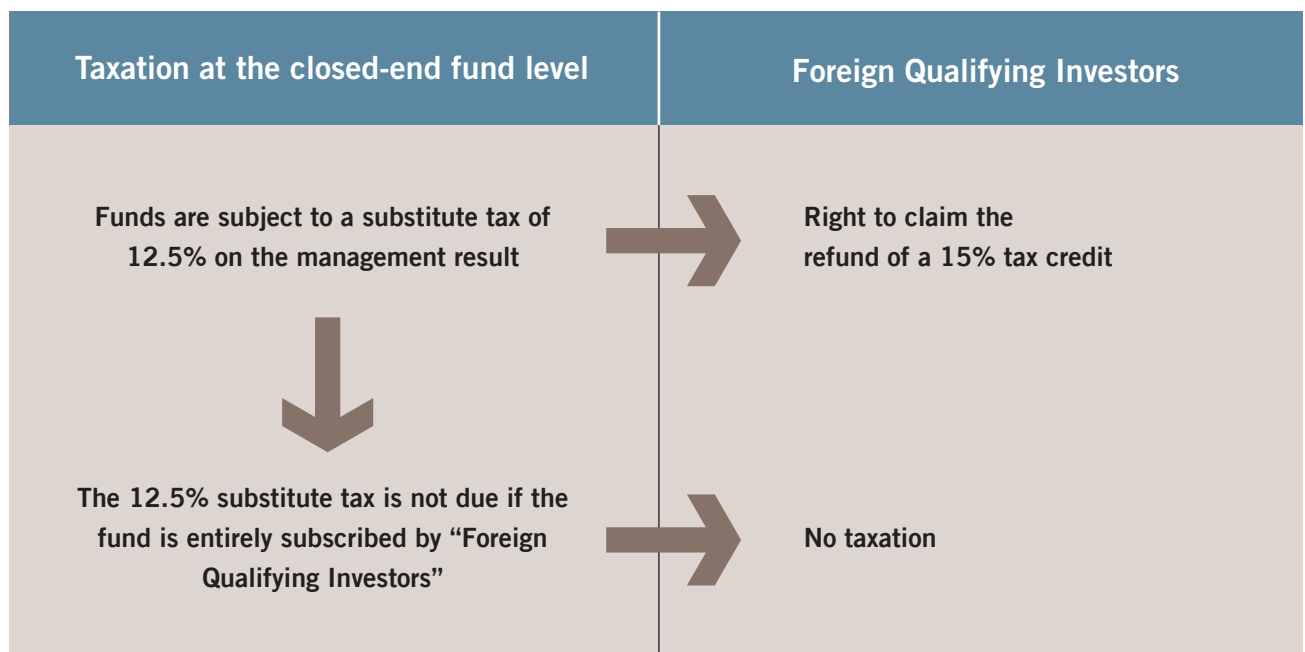
Proceeds received by banks, insurance companies and financial entities may also form part of the taxable basis subject to IRAP which applies at a rate of 3.9% (the rate may be increased up to 4.9% depending on the Italian region in which regional production tax is payable).

2.2 | General Principles of taxation of SGRs

SGRs are subject to IRES in accordance with provisions that generally apply to Italian companies, while specific provisions are set out with respect to IRAP.

Fees charged to the fund by the SGR in connection with its management activity are VAT exempt from Italian VAT and the fund does not bear the cost of VAT for the asset management services rendered by the SGR.

On the other hand, SGRs have usually limited or no right to recover VAT incurred to the extent that they carry out VAT exempt services.



3 | Deal structuring

Asset deals and share deals generate differences in terms of:

- a) ability of the seller to minimise capital gain tax;
- b) possibility for the purchaser to recognise the tax base cost (e.g. for goodwill) from the purchase price paid;
- c) ability to obtain effective tax relief on debt pushed down into the structure.

The principle features of the key tax factors in structuring a deal listed above are analysed below.

3.1 | Asset deal

The acquisition of a business for consideration does not require an expert opinion on the value of the business transferred. However, an expert valuation may be necessary in the case of a contribution in kind of a business in exchange for shares of the receiving company.

On a business acquisition for cash the price paid by the purchaser is recognised for tax purposes. The capital gain (if any) realised by the seller is subject to IRES tax at 27.5%. The capital gain on the disposal of a business is not subject to IRAP (3.9%) provided that it consists of a sale of a going concern and not simply a series of individual assets. On the other hand, on a contribution in kind of assets and liabilities, any capital gain realised by the contributing company will not be subject to IRES (tax neutrality regime); the receiving company may elect to step up values by paying a substitute tax.

The transfer of a business consisting of a going concern for cash is outside the scope of VAT and is subject to a registration tax of 3% calculated on the sale price, including goodwill. The Tax Authorities may carry out adjustments to

the value of the goodwill, if not in line with the principle of an arm's length transaction, and levy a higher amount of tax. The taxpayer has a right of appeal to the Courts, but generally is required to make partial payment of the extra tax assessed before so doing.

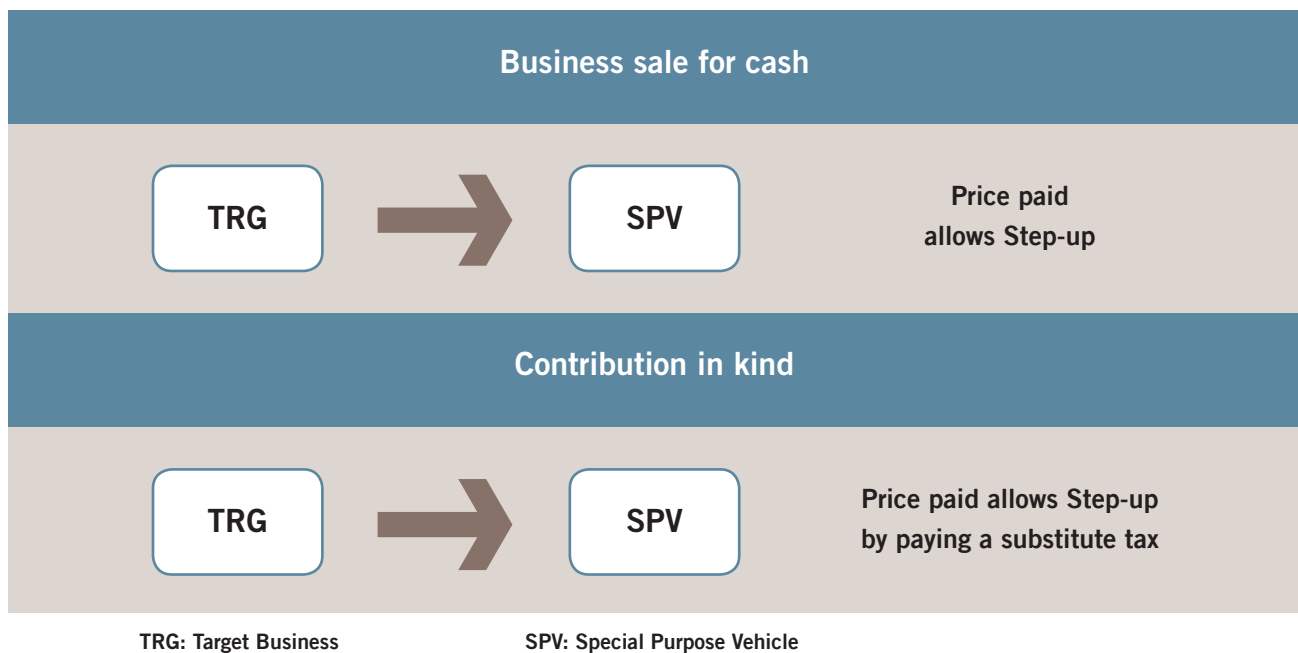
A registration tax of up to 7% - 8% - 15% (plus a land registry tax of 1% and a mortgage tax of 2%) is payable on the acquisition of real estate included in the business transferred. Liabilities included in the business can be attributed, only for registration tax purposes, to real estate and other assets, in proportion to their value for the purposes of applying the different tax rates.

The contribution in kind of a business is outside the scope of VAT and is subject to a fixed lump sum of registration tax, land registry tax and mortgage tax equal to € 168 each.

3.2 | Asset deal – Allocation of purchase price

The purchase price paid in cash for the business forms the taxable basis for the purchaser. Tax amortisation is then determined according to fixed depreciation rates: for example goodwill recorded in the purchaser's books may be amortised for tax purposes on a straight-line basis at a maximum rate of 5.56% in each tax period.

The ITC provides for a tax neutral regime for business contributions in kind. The aim of this regime is to facilitate business reorganisations. Thus, capital gains are not taxed at the time of the contribution in kind. The consequence for the receiving company is to inherit the tax values of the assets and liabilities of the business existing at the time of the transaction in the tax books of the contributing entity. Any goodwill



and/or asset step-up arising from the transaction (which is not subject to tax) is not recognised for tax purposes even if recorded in the receiving company's books for accounting purposes (continuity principle). The asset and liabilities accounting and tax recognised base is consequently different for the purchaser. A special reconciliation schedule, showing the differences between accounting and tax values, must be completed as part of the relevant annual income tax return of the receiving company.

The company receiving a contribution in kind may elect for the application, on all or part of the additional values allocated to tangible and intangible assets of the business transferred, of a substitute tax, at the following rates:

- 12% on additional values of up to 5 million Euro;

- 14% on the portion of additional values above 5 and up to 10 million Euro;
- 16% on the portion of additional values over 10 million Euro.

In this event, the receiving entity obtains tax recognition for the assets and/or the goodwill received and may depreciate them according to the approved tax depreciation rates.

The same elective regime is available to the absorbing or surviving company in a merger or to the company receiving a demerged business in respect of the additional values recorded in the financial statements as a result of the corporate reorganisation.

3.3 | Share Deal

The stock transfer may occur by way of purchase in cash or by way of contribution in kind in exchange for shares of the receiving company.

The stock transfer does not require an expert opinion on the value of the shareholding transferred. However, an expert valuation may be necessary in the case of contribution of shares or when the seller participate to the SPV.

Any capital gain realised upon disposal of shares may be subject to the IRES standard rate (27.5%). Gains realised by holding entities may be subject to IRAP as well.

The new ITC provides for a 95% participation exemption on gains from shareholdings (regardless of the value or the percentage owned) in resident and non-resident companies with or without legal personality, when the following conditions are met:

- a) the shareholding must have been held without interruption from the first day of the twelfth month prior to the month of the sale. In the event that the shares are sold in several instalments, shares purchased more recently are deemed to be sold first (LIFO basis);
- b) the shareholding is classified among financial fixed assets in the selling company's first financial statement that ended during the period of the ownership;
- c) the subsidiary is located in a "white list" country - this is a list of countries which will be identified by the Ministry of Finance, unless a ruling request is filed with the tax authorities;
- d) the subsidiary carries out a commercial activity. This condition is automatically deemed to not apply for real estate companies as defined, other than companies that trade or construct real estate or companies which own

real estate for the purposes of carrying out a commercial activity.

These conditions, namely the location of the subsidiary in a white listed country and the conduct of a commercial activity, must be met continuously from the beginning of the third accounting period prior to the date of disposal of the shares.

Where shares are held through holding companies whose activity is exclusively or mainly the ownership of shareholdings, the conditions described in letters a) and b) above must be met with respect to the shares owned in the holding company.

The conditions under letters c) and d) must be met by the indirect subsidiaries whose current value exceeds 50% of the current value of the holding company's net equity.

These rules also provide that the following are not deductible for tax purposes:

- all write-downs and losses resulting from shareholdings recorded among financial assets which satisfy the participation exemption requirements under letters b), c) and d), held for more than twelve months;
- financial costs relating to the purchase of shareholdings which on disposal will qualify for the participation exemption.

The stock disposal is subject to a fixed lump sum of registration tax equal to e 168.

3.4 | Share Deal - Allocation of purchase price

After the share acquisition is performed, the tax base cost for the purchaser is represented by the purchase price but there is no possibility of election for the step-up of the taxable basis of the assets of the acquired company.

Effective tax relief may not be obtained either in the future when the participation exemption applies, through a write-off of the cost of the shares or through the allocation of any loss on consolidation pursuant to a merger (the difference between price paid and equity book value of the subsidiary) by absorption of the subsidiary (the tax neutrality regime applies to mergers unless a substitutive tax, as mentioned above, is paid).

Thus, conflicts may arise between the interests of the purchaser and the seller. Comparing the tax treatment applicable to a share disposal for a cash consideration with a business disposal for a cash consideration, it emerges that only through negotiation may there be a combination of the seller's interest in benefiting from the participation exemption regime and the purchaser's interest in obtaining a stepped up tax basis in the acquired business through recognition of the price paid or, by paying a substitute tax, on the loss on consolidation resulting from a possible merger.

3.5 | Interest expenses restrictions

The limitations on interest deduction have been materially changed by the Finance Act 2008. In particular the thin capitalization rule and the asset pro-rata restrictions (aimed at limiting the deduction of interest expenses for debt funding financing the acquisition of shareholdings qualifying for the participation exemption regime) have been abrogated.

The above mentioned restrictions on interest deduction, based on the net equity consistency, have been replaced by a general limitation based on a gross operating income test.

Pursuant to the new rule, interest expense and other similar costs are deductible up to the amount of interest income and other similar proceeds. The excess of interest expense is deductible up to 30% of the gross operating result (broadly corresponding to EBITDA) from the company's characteristic business. The gross operating result is determined as the difference between revenue and expenses (first paragraph, letters A) and B) of art. 2425 of the Italian Civil Code) with the exclusion of depreciation, amortisation and finance lease payments.

	Share Deal	Asset Deal
Seller	Participation exemption	27.5%
Purchaser	No step-up	Step-up
	Step-up by paying a substitute tax	

In particular:

+ A) Revenues:
1) Revenues from sales and services
2) Variations in stocks of work in progress, semi-finished and finished products
3) Variations in work in progress on commission
4) Increments in fixed assets as a result of internal work
5) Other revenues and income
- B) Expenses:
6) Costs for raw materials, subsidiary materials, consumables and goods
7) Costs for services
8) Costs for the use of property of third parties (rent/lease)
9) Employees and related costs
10) Tangible and intangible fixed assets depreciation and devaluation
11) Variations in stocks of raw materials, subsidiary materials, consumables and goods
12) Provisions for liabilities and charges
13) Other provisions
14) Sundry operating charges
+ Depreciation of intangible assets
+ Depreciation of tangible assets
+ Finance lease payments
= R.O.L. (Gross Operating Result)

The rules apply to interest expense and interest income as well as any similar costs and income deriving from long-term loan agreements, finance lease agreements, issuance of bonds and similar securities and any other financial arrangements, with the exclusion of implicit interest deriving from trade payables.

For the purposes of the calculation of the gross operating result, interest income includes also that deriving from trade

receivables and, for entities which carry on business with the Public Authorities, the virtual interest related to late payment.

The limitations described above do not apply to interest expenses that are capitalized over the cost of tangible or intangible assets in accordance with applicable law provisions and accounting principles. This provision may be relevant during the start-up phase of a company or in connection with the development of specific assets to the extent that capitalised interest expenses remain fully deductible for IRES purposes either through amortisation and depreciation charges or as part of the tax base of the asset upon its sale.

The portion of gross operating margin realized as of the third fiscal year subsequent to that current at 31 December 2007, not used for the deduction of the interest expense and financial costs for the year, may be carried over to increase the gross operating margin of subsequent fiscal years.

The interest expense and other similar costs not deductible in a given fiscal year will be deducted from the income of the subsequent fiscal years if and to the extent that in such periods the amount of interest expense and other similar costs accrued in excess of the interest income and other similar proceeds is less than 30% of the gross operating result for that year.

For the first and the second Fiscal Year of application of the new rules (FY 2008 and 2009), the threshold for the deductibility of interest expense shall be increased respectively by Euro 10,000 and Euro 5,000.

The following example describes the computation for the portion of interest expenses not deductible according to the above rule.

FY 2008

A) Revenues	+	10,000,000
B) Expenses	-	9,500,000
Difference	=	500,000
Depreciation of intangible assets	+	50,000
Depreciation of tangible assets	+	50,000
Finance lease payments	+	80,000
R.O.L.	=	680,000
30% R.O.L.		204,000
Deductible amount of interest expense + € 10,000	+	214,000
Interest expense	+	300,000
Interest income	-	25,000
Net Interest Expense	=	275,000
Non-deductible amount of interest expense on the FY 2008 ¹	=	61,000

FY 2009

A) Revenues	+	10,800,000
B) Expenses	-	10,200,000
Difference	=	600,000
Depreciation of intangible assets	+	50,000
Depreciation of tangible assets	+	150,000
Finance lease payments	+	100,000
R.O.L.	=	900,000
30% R.O.L.		270,000
Deductible amount of interest expense + € 5,000		275,000
Interest expense	+	280,000
Interest income	-	30,000
Net Interest Expense	=	250,000
Non-deductible amount of interest expense on the FY 2008	=	61,000
Non-deductible amount of interest expense on the FY 2009 ²	=	0
Non-deductible amount of interest expense carry forward ³	=	36,000

¹ Non-deductible amount of interest expense on the FY 2008 = € 275,000 - € 214,000.

² Non-deductible amount of interest expense on the FY 2009 = € 275,000 > € 250,000.

³ Non-deductible amount of interest expense carry forward = € 61,000 - € 25,000.

The following companies and entities shall fall outside the scope of the rules:

- banks and other financial entities;
- consortium companies incorporated for the full or partial execution of works;
- project financing companies;
- companies incorporated for the creation and operation of interports;
- companies whose share capital is mainly subscribed by public entities, which create or manage equipment for the supply of water, electric power and central heating as well as waste processing and purification equipment.

On the contrary, the new provision applies to holding companies which are exclusively or mainly engaged in the acquisition of shareholdings in companies carrying out activities other than in the credit or financial sector.

The above rules will not affect the full non-deductibility of costs and other expenses relating to property not used in the conduct of business.

3.5.1 Domestic Group Taxation

If the option for Domestic Group Taxation has been elected, any excess interest expense and similar costs may reduce the group's aggregate income if and to the extent that other companies within the tax group have, for the same fiscal year, a gross operating income not fully used for the deduction of interest expense and similar financial costs. This rule applies also to excess interest expense and similar costs carried over, except those arisen before the election for the tax group.

Foreign subsidiaries which respect specific conditions (identical fiscal year and audited Financial Statements) may be virtually considered as part of the tax group. In this respect the virtual inclusion of a foreign company is always optional and must not necessarily take place in the subsequent years.

3.5.2 Merger

In the event of merger, certain restrictions prescribed for the carry forward of tax losses (equity and activity test) also apply to previous years non-deductible interest to be carried forward.

4 | Post acquisition restructuring and spin-off of properties

Private equity investors may be interested in considering the spin-off of properties as part of restructuring of assets after the acquisition of Italian companies.

4.1 | Overview of tax implications of the sale of properties

4.1.1 Direct taxes

Capital gains realized by an Italian company on the sale of instrumental properties form part of the taxable basis subject to ordinary taxation.

The capital gain (or loss) realised for the disposal of the property is calculated as the difference between the price of sale and the cost of acquisition, increased by ancillary costs or capital expenditures capitalised over the value of the property in accordance with accounting principles.

The capital gain realized on the sale of properties may be taxed in equal instalments over a period up to five fiscal years provided that a minimum holding period of three calendar years is met and the option for the deferred taxation is exercised.

The price for the sale should reflect the market value of the property at the time of the transfer, considering the average price paid for similar properties in current free market conditions.

4.1.2 VAT regime

The VAT regime of the sale of properties by a company depends on the legal and cadastral qualification of the property and also on the subjective status of both the seller and the purchaser.

In general terms, the sale by a company of instrumental property having cadastral qualification for non-residential use falls within the scope of application of VAT. However, the transaction may be either VAT exempt or subject to VAT depending on the subjective status of the seller and the purchaser and, under certain circumstances, on whether the option for the applicability of VAT is exercised.

4.1.3 Transfer taxes

The transfer of instrumental properties by a company is subject to registration tax in the fixed amount of Euro 168 and proportional 3% mortgage tax and 1% cadastral tax. The mortgage and cadastral taxes may be reduced to 1,5% and 0,5% respectively in the case of sale to an Italian real estate fund, a SIIQ or to financial intermediaries that act in connection with a financial lease activity.

4.2 | Contribution of properties to a SIIQ or an Italian real estate fund

A special tax regime may apply for both direct and indirect taxes in the case of contribution of properties by a company to a SIIQ (or a company controlled by a SIIQ) or an Italian real estate fund.

4.2.1 Direct taxes

Contribution of properties by a company to a SIIQ or Italian real estate fund, in which the company receives shares of the SIIQ or units of the Italian real estate fund as a consideration for the contribution of the property, gives rise to the

same direct tax implications that arise in the case of sale, as summarised above.

However, the contribution of properties by a company to a SIIQ or an Italian real estate fund may be subject to a 20% substitutive tax that applies in place of IRES and IRAP by option of the contributing company.

In the case of contribution to a SIIQ, a minimum holding period of 3 years applies in the hands of the SIIQ in order to avoid that ordinary taxation applies on the capital gains realised on the subsequent sale by making reference to the cost recognised in the hands of the contributing company rather than to the higher value taken into account for the purpose of the application of the 20% substitutive tax upon contribution of the property.

The 20% substitutive tax may be paid by the contributing company in equal instalments over a 5-year period. Interest equal to the official rate increased by 1% applies on the amount of the instalments.

4.2.2 Indirect taxes

The contribution of properties to a SIIQ or Italian real estate fund is subject to VAT as well as mortgage and cadastral taxes in accordance with the same principles that apply in the case of sale of properties.

However, the contribution to a SIIQ or an Italian real estate fund of a pool of properties the majority of which is leased to third parties is regarded as a contribution of “business concern” for indirect taxes purposes. Accordingly, the transaction falls outside the scope of VAT and registration, cadastral and mortgage taxes apply in fixed amounts of Euro 168 each.

4.3 | Overview of the tax regime of Italian real estate funds

SGRs may set up and manage closed-end funds the sole or main purpose of which is to invest in real estate properties, real estate rights or shareholdings in real estate companies. Italian closed-end real estate funds are regulated by CFA (Consolidated Finance Act) as closed end funds that invest in private equity deals and operate within a substantially similar regulatory framework, save for those matters connected with the different nature of their investment.

Closed-end real estate funds are subject to a tax regime that differs from the one applicable to closed-end private equity funds.

Italian real estate funds are not subject to IRES or IRAP and are not subject to any substitutive tax levied at the fund level.

In the case of direct acquisition and holding of properties located in Italy, rental income and capital gains are not subject to taxation in the hands of the fund.

The general rule provides that income collected by real estate funds on ancillary financial investments (including interest from loans, interest from bank accounts and Government bonds or bonds issued by listed companies or banks) is gross of Italian withholding taxes at source or substitute taxes, although the fund may suffer definitive withholding taxes on certain categories of financial income.

In the case of foreign-source income, applicability of withholding taxes at source in foreign jurisdictions must be evaluated case-by-case.

The ability of a real estate fund to recover VAT on the acquisition of real estate assets and on maintenance costs is

similar to that of Italian companies performing real estate transactions, although the law establishes cases of derogation from the general principles. VAT duties related to transactions of a real estate fund are carried out by the SGR in accordance with the general principles concerning the application of VAT. The VAT position of the fund is autonomous from that of the SGR.

A 20% withholding tax must be levied by the SGR on proceeds that are collected by the investors in the real estate fund upon: (a) distribution of periodical proceeds; and (b) redemption of units. Under certain conditions, the withholding tax agents' obligations are fulfilled by other Italian financial intermediaries that take part in the collection of proceeds by investors.

In the case of Italian resident persons, the 20% withholding tax is levied as definitive payment or as advance payment of taxes due, depending on the tax status of the investor. The withholding tax does not apply to certain Italian resident investors, such as Italian undertakings for collective investment or Italian pension funds.

The 20% withholding tax is levied as definitive payment of taxes due in Italy by non-Italian resident investors that do not have a permanent establishment in Italy to which income deriving from the real estate fund may be attributed for tax purposes.

However, the 20% withholding does not apply on proceeds collected by Foreign Qualifying Investors that satisfy certain requirements. Under certain circumstances, Foreign Qualifying Investors may therefore benefit of the exemption from income tax purposes at the level of the real estate fund and the further exemption from any Italian withholding tax on proceeds arising from the investment in the real estate fund.

Foreign Qualifying Investors that intend to benefit of the exemption regime must submit to the SGR appropriate declarations attesting that the conditions requested by applicable law and regulations are satisfied.

Under certain conditions, Italian real estate funds may be subject to an annual 1% net wealth tax calculated on the net asset value of fund. In general terms, 1% net wealth tax may apply to real estate funds the units of which are not destined to be listed on a regulated market and have an asset value lower than Euro 400 million when certain conditions are met.

4.4 | Overview of the tax regime of Italian real estate investment companies (SIIQ)

Italian real estate investment companies (SIIQ – *Società di Investimento Immobiliare Quotate*) may benefit of a favourable tax regime subject to certain requirements being satisfied.

4.4.1 Requirements concerning the listing of shares and investors in a SIIQ

Shares of a SIIQ must be traded on a regulated Italian market. No shareholder may own, directly or indirectly, more than 51% of the voting rights in the ordinary shareholders' meeting of the company and of the profit-sharing.

At least 35% of shares must be held by shareholders that do not own, directly or indirectly, more than 1% of the voting rights in the ordinary shareholders' meeting of the company and of the profit-sharing.

The main activity of the company must be the letting of real estate property. This condition is satisfied provided that: (a) properties owned by the company for letting purposes represent at least 80% of total assets; and (b) revenues arising from the letting activity represent at least 80% of total revenues in each fiscal year.

Shareholdings in other SIIQs (or companies controlled by SIIQs) that are held as fixed financial assets and the portion of dividends attributable to the letting activity carried out by said companies are taken into account for the purpose of calculating the thresholds above.

If one of the two thresholds is not satisfied for two consecutive fiscal years, the SIIQ status is disregarded and the ordinary regime of taxation applies starting from the second year during which the condition is not satisfied.

4.4.2 Requirements concerning the distribution policy

A SIIQ must distribute to shareholders at least 85% of the profit arising from the renting activity and from shareholdings in other SIIQs (or companies controlled by SIIQs).

If the accounting profit available for distribution according to corporate law provisions is lower than the profit arising from the letting activity and from shareholdings in other SIIQs (or companies controlled by SIIQs), the 85% distribution requirement applies with respect to the lower amount of accounting profit available for distribution.

If the distribution requirement is not satisfied, the company loses the SIIQ status starting from the same fiscal year during which the profit not distributed accrued.

4.4.3 Tax regime of the SIIQ

Income arising in the hands of a SIIQ from the letting activity is exempt from IRES and IRAP.

Dividends arising from shareholdings in other SIIQs or companies controlled by SIIQs that are held as fixed financial assets benefit of the exemption regime for the portion attributable to the letting activity carried out by said companies.

4.4.4 Tax implications of the switch from the ordinary tax regime to the SIIQ status

The option for the attribution of the SIIQ status by existing companies represents a taxable event with respect to properties that are owned by the company and that will be used within the exempt letting activity.

Capital gains, net of capital losses, arising from the difference between the market value of the properties, on one side, and the value recognised for tax purposes to the same properties, on the other side, is subject to a 20% exit tax that substitutes IRES and IRAP.

The market value of the real estate considered for the purpose of application of the 20% exit tax is recognised as the new value recognised for tax purposes starting from the fourth fiscal year following the fiscal year preceding the switch to the SIIQ status. If properties are sold prior to such period, capital gains are determined taking into account the value recognised for tax purposes prior to the switch to the SIIQ status. In such a case, the portion of the 20% exit tax attributable to the real estate represents a tax credit for the company.

The 20% exit tax may apply also in relation to properties that are held for the purpose of their subsequent sale and will not be used by the SIIQ within the exempt letting activity, subject to the deferral of the tax effects of the step-up.

Tax losses of fiscal years preceding the acquisition of the SIIQ status may be carried forward in order to offset: (a) the 20% exit tax due upon the switch to the SIIQ status; or (b) any taxable profit arising from activities other than the exempt letting activity.

As an alternative to the option for the 20% exit tax, capital gains, net of capital losses, may be included in the business income of the company for the fiscal year preceding the year of acquisition of the SIIQ status and be subject to ordinary taxation.

4.4.5 Tax regime of investors

The portion of dividends distributed by a SIIQ and attributable to the exempt letting activity is subject to a 20% withholding tax at source to be levied by the authorised financial intermediaries identified in accordance with law provisions.

The withholding tax may be reduced to 15% on the portion of dividends attributable to the letting of residential properties that satisfy certain conditions.

In the case of Italian resident investors, the withholding tax is levied as definitive payment or as advance payment of taxes due, depending on the tax status of the investor.

The withholding tax is levied on account of total income tax due if the recipient is:

- a) an Italian individual who holds the shares of the SIIQ in connection with a business activity;

- b) an Italian resident partnership or an entity regarded as a partnership for tax purposes;
- c) an Italian resident company;
- d) a permanent establishment in Italy of a non-resident person.

Proceeds collected by the investors above are subject to taxation in accordance with the specific tax regime applicable to each of them.

Dividends collected by Italian resident companies cannot benefit of the participation exemption and the 95% exclusion from taxation that usually applies to dividends distributed by companies.

The withholding tax is levied as definitive payment in all other cases, including Italian individual investors that hold the shares of the SIIQ other than in relation with a business activity and non-Italian resident persons.

The 20% withholding tax on dividends distributed to non-Italian resident persons out of profits arising from the exempt letting activity cannot be reduced by application of the provisions implementing the EU Parent-Subsidiary Directive

No withholding tax applies if the recipient is an Italian undertaking for collective investment or an Italian pension fund.

Capital gains realised by Italian resident companies or individuals on the sale of shares in a SIIQ cannot benefit from the participation exemption regime. However, the cost of the shares recognised for tax purposes in the hands of the investors in the SIIQ is increased by the portion of the retained profits arising from the activity which is subject to ordinary taxation in the hands of the SIIQ.

5 | Exit strategy

At the early stage of an investment a Private Equity investor generally considers a divestment strategy that could be followed to maximise the return on investment. The effective execution of the expected exit strategy depends on the state of business of the target company, on the conditions of the market in which it operates, on the situation of the financial markets at the time of divestment and on the type of disposal that will be carried out.

5.1 | Share Deal

Disposal of the target participation to strategic industrial investors or to Private Equity houses may be carried out through the direct sale of the shareholding. In that event if the disposal is carried out by the resident fund the gain will be taxable applying a substitute income tax of 12.5% or be tax exempt under the fund taxation rules set out in paragraph 2.1.1.

On the other hand if a resident holding company sells its shareholdings, reduced taxation applies provided that the requirements for the participation exemption regime are met (see section 3.3). If the exemption regime may not be applied, IRES (27.5%) will apply on any gain. IRAP may apply as well.

If the disposal is realised by a foreign holding company the gain, if any, will normally be taxable only in the jurisdiction of residence of the holding company according to most treaties against double taxation entered into by Italy, provided that the treaty conditions are satisfied. However, an exception to this principle exists in some cases. For instance, the treaty with France permits Italy to tax disposals of significant shareholdings (greater than 25%) and some treaties permit

Italy to tax the disposal of shares in real estate holding companies.

5.2 | IPO – Initial Public Offering

A different divestment strategy consists in the listing of an investment company.

In this respect, if the fund makes a disposal of its shares, partially or as a whole (by way of public listing) the capital gain, if any, will represent part of the management result and so will be taxed at the 12.5% substitute tax rate or will be tax exempt as set out in section 2.1.1.

Should the holding company list in the market all or part of the existing stock in the subsidiary, any gain will be partially taxable if the participation exemption applies. If not, the gain will be subject to IRES at the 27.5% rate (see paragraph 5.1). IRAP may apply as well.

However, the impact of a listing may be to reduce the parent's shareholding below 51%, in which case the subsidiary may no longer be part of the related tax grouping and the claw back rule may apply.

5.3 | Asset Deal

When a share deal is not feasible (e.g. where only a part of the business is to be transferred) an alternative two-step strategy is available as follows:

- carry out a contribution in kind of the business to a NewCo;
- sell the NewCo shares.

The contribution may involve either the whole business concern or a single division of the business and may be carried out under the tax neutral regime, whereby no taxation arises in the hands of the contributing company (holding company), as described in section 3.2.

The holding company, which holds the shares of the contributed company, NewCo, could then immediately sell NewCo applying the participation exemption regime (providing the business was held by the holding company for at least twelve months prior to the contribution). Therefore reduced taxation will arise at the holding company level.

This solution is expressly outside the generic anti-avoidance rules which deny a tax deduction for tax advantages resulting from transactions carried out for non commercial purpose.

5.4 | Leveraged recapitalization

Leveraged recapitalization does not represent a classic way out, as it does not trigger any change of control over the target.

Implementing a leveraged recapitalization in Italy requires a detailed case-by-case analysis not only from a tax perspective, but also from a corporate law standpoint.

6 | Management incentives

The Italian tax treatment of capital gains and stock options may offer tax optimised opportunities for target managers, although recent law changes (Decree 223/06) may limit its tax efficiency.

6.1 | Capital gains

The tax regime for capital gains deriving from the disposal of shares has been modified, effective from 1 January 2004.

6.1.1 Resident individuals

The taxation of capital gains depends on the size of the shareholding. “Significant” shareholdings are those which exceed 20% of capital, for shares carrying voting rights, or 25% in case of non-voting shares. The 20% and 25% limits are reduced to 5% and 2% respectively in the case of listed companies.

Forty percent (49,72%, starting from disposal effected after 1 January 2009) of capital gains on disposal of significant shareholdings, in both resident and non-resident companies are included in the personal taxable income of the shareholder and this portion is subject to the taxpayer's marginal tax rate (from 23% to 45.2% for FY 2008, including regional and municipal rates).

Forty percent (49,72%, starting from 1 January 2009) of capital losses may be carried forward and offset against future capital gains.

Capital gains on the disposal of non-significant shareholdings, in both resident and non-resident companies are taxed separately (i.e. do not form part of total income) at a flat

rate of 12.5%. Capital losses may be carried forward for 4 years.

Capital gains arising from the disposal of shareholdings (significant and non-significant) in unlisted shares companies located in non “white listed” countries are fully subject to tax at the individual marginal tax rates.

This capital gain tax treatment may also apply to co-investment schemes and to derivative products related to venture capital backed companies. These equity participation and co-investment schemes are becoming more common after the repealing of special stock option regime (see par. 6.2).

6.1.2 Non-resident individuals

Capital gains deriving from the disposal of shares of Italian resident companies are subject to tax in Italy, with the exception of capital gains deriving from disposal of non-significant shareholdings in Italian listed companies.

The liability to tax in Italy on any capital gains deriving from the disposal of shares in Italian resident companies will depend on the applicable double tax treaty. As general rule, art. 13 of most of Italy's double tax treaties provides for taxation exclusively in the country of residence of the seller.

6.1.3 Capital gain on start-up – special tax regime

Starting from 25 June 2008 (Decree 112/2008), capital gains deriving from a disposal of significant and non-significant shareholdings held for at least 3 years in Italian resident company (subject to corporate tax) incorporated less than 7 years ago are tax exempt providing that the taxpayer, within 2 years from the disposal, reinvests the gain to purchase

shares or subscribe shares capital of Italian resident start-up (incorporated not less than 3 years before) companies having the same business purposes of the company sold. The exempt capital gain cannot exceed 5 times the cost borne by the company, the taxpayer has disposed of, to purchase tangible or intangible asset (different from real estate property) and / or research and development cost.

6.2 | Stock Options

The Italian stock options favourable tax regime has been recently repealed (Decree 112/2008) after several amendments (hereinafter briefly summarised) occurred over the last two years.

As a general rule, non tradable stock options granted to a manager become taxable in his or her hands only at the date of exercise, when the employee becomes the owner of the shares. Under the current regime, which applies to the exercise of options occurred after 25 June 2008, regardless the date of grant of the options, the income deriving from the exercise of the options is considered as employment income, and as such subject to income tax. The Decree 112/2008 has provided the full exemption from social security of income deriving from stock options exercise.

At the exercise date, the difference between (i) the “market value” of the shares at the exercise date and (ii) the price paid by the employee, if any, is considered as taxable income from employment, for income tax purposes only.

According to the ITC, the “market value” is defined as the average settlement price during the month preceding the exercise for shares, bonds and other securities listed on the stock

exchange. For non-listed companies the market value will be the relevant proportion of the fair value of the company.

An Italian employer has the obligation to withhold income tax even if the share options are granted by a third party.

If the shares are sold subsequent to exercise, the seller will be subject to tax on any capital gain as described above, the gain being the difference between sale price and market value on the date of the exercise of the options, less deductible costs (i.e. transaction cost, broker fees, etc.).

6.2.1 Exemption regime for share options (no longer applicable)

Notwithstanding the general regime described above, the ITC provided, before recent changes in the law, a special tax regime for share options when the following conditions were satisfied:

1. the exercise price was, at minimum, equal to the “market value” of the shares at the grant date;
2. the amount of shares (or related option rights) assigned to each employee did not exceed 10% of the voting rights in the ordinary shareholders’ meeting or 10% of the capital or equity of the offering company;
3. the options were not freely tradable;
4. the shares were issued by the employer or an employer - related company.

If the above conditions were met, then the difference between the “market value” of the shares at the exercise date, and the amount paid by the employee to purchase the shares, was not taxable as employment income, but any gain on subsequent sale of the shares was subject to tax (12.5% for non-significant shareholdings). The gain was calculated

as the difference between exercise price and sale consideration, less deductible costs.

The exemption regime was also available to non-employee directors.

6.2.2 Amendment of exemption regime for stock options

On 4 July 2006, the Italian government issued a decree to amend the tax-favourable regime for employee stock options. (Decree No. 223 became effective, with respect to stock options, on 5 July).

Under the proposed tax regime, any built-in gains for options exercised beginning on 5 July 2006 would not be subject to ordinary withholding tax upon exercise of the options if, in addition to the conditions set out in paragraph 6.2.1:

- the shares are not be disposed of or provided as guarantee, within five years from the exercise date;
- the value of the shares is no higher than the employee's gross income for the previous year.

On 3 October 2006 the regime for employee stock options was modified again and the conditions to be satisfied under that regime, in addition to those set out in paragraph 6.2.1 were:

- options cannot be exercised for 3 years from grant date (mandatory non-exercisability period); and
- shares underlying options shall be of listed companies (OECD's country stock exchange) at the end of the 3 years non-exercisability period; and
- the employee, upon exercise, shall invest in company's share an amount equal to the difference between normal value of shares at exercise and the exercise price (the spread) for a 5-year-period; during the 5 years holding

period the shares cannot be sold, pledged or otherwise used as a guarantee.

If the shares were disposed of or provided as guarantee before the expiration of the 5-year-period, the gain which was not taxed at the exercise date became taxable in the tax period in which the shares were disposed of or provided as guarantee.

6.2.3 Cancellation of exemption regime for stock options

As mentioned above, the Law 112/08 has abolished the favourable tax regime for stock options, then all the stock options exercised since 25 June 2008 cannot benefit of any exemption for tax purposes, even if stock option plans were implemented before this date.

6.3 | Summary scheme

The table below will summarise the different rules applicable for the different periods.

	Prior to 5 July 2006	From 5 July 2006 to 2 October 2006	From 3 October 2006 to 24 June 2008	Since 25 June 2008
Personal income taxation (exemption regime)	12.5%*(sale price - “market value”). Taxes had to be paid only when the shares were sold			Exemption regime abolished
Conditions for exemption	The exercise price was, at least, equal to the “market value” of the shares at the grant date			
	The amount of shares (or related option rights) assigned to each employee did not exceed 10% of the voting rights in the ordinary shareholders’ meeting or 10% of the capital or equity of the offering company;			
	Options not freely tradable			
	Shares issued by the employer or an employer - related company			
		Value of the shares is no higher than the employee’s gross income for the previous year.	Options exercised only after three years from the grant date	
	The shares are not be disposed of or provided as guarantee, within five years from the exercise date	Five years holding period for an amount of shares equal to the difference between the “market value” of shares and the option price.		
Personal income taxation (not under exemption regime)	The difference between the “market value” and the exercise price is taxed by ordinary tax rates, while the difference between the sale price and the “market value” is taxed by 12.5% tax rate			
Social security contribution	Exemption providing that the same conditions as per tax purposes are satisfied, otherwise fully subject to social taxes	Exemption providing that: <ul style="list-style-type: none"> • the same conditions as per tax purposes before 5 July 2006 are satisfied, • the stock option plan was approved before 4 July 2006, otherwise fully subject to social taxes		Exempt

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