Private Equity Focus Team

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LBOs (mergers) and deductibility of interest expenses: interesting developments with Italian Supreme Court decision of July

In Decision No. 19430 of 20 July 2018, the Italian Supreme Court overturned some (minority) Supreme Court precedents and established the following general principle.

A limited company ("società di capitali") may deduct interest expenses without assessing whether they are connected to the business activity.

This principle also applies to LBOs, for which the Italian Tax Authority has (in some cases) denied interest expense deductions in relation to loans taken out by a newco to purchase the target company, due to the presumed lack of connection (*inerenza*) between the business activity and the interest expenses (or, to be more exact, the loans on which the interest accrues).

Even though the decision does not remove all other possible grounds for denial, it should be **received favourably** by private equity firms. That said, the Italian Tax Authority could – in certain "**exceptional**" LBO cases – still deny interest expense deductions in relation to loans taken out to complete the acquisition, based on the rules on abuse of law. Nonetheless, the principle established by the Supreme Court provides useful guidance for defence counsel.

1. The "connection" between interest expenses and the business activity: in general ...

The Supreme Court has addressed the question of the relevance of the connection to determine the deductability of interest expenses (for limited companies) on several occasions, which have led to two strands of caselaw:

Prevalent strand of caselaw: Unlike other expenses incurred to generate income, interest expenses **do not need to be connected to the business activity** (Supreme Court Decision Nos. 12246/2010, 10501/2014, 21467/2014, 6204/2015 and 4339/2016).

Secondary strand of caselaw: Interest expenses are deductible only if the interest relates to a loan taken out to generate revenue subject to taxation as business income (Supreme Court Decision Nos. 24930/2011 and 4115/2014).

The decision under discussion falls under the prevalent strand and highlights that the general provision on this matter (Art. 109(5) of Italian Consolidated Income Tax Law – TUIR) applies to "expenses and costs other than interest expenses". This shows that the legislature clearly intended that interest expenses be treated differently, i.e., **as not requiring any connection to the business activity** to be deductible.

This interpretation is consistent with the mechanism of flat-rate deduction of interest expenses (i.e., within 30% of EBITDA) available to limited companies under Art. 96 of the TUIR, which (both in the current text and in that of the draft of the legislative decree implementing EU Directive 2016/1164) does not require an assessment of the connection between the interest expenses and the business activity (unlike Art. 61 of the TUIR, which applies to sole partnerships and persons subject to personal income tax – IRPEF).

2. .... LBO transactions

The connection between interest expenses and business activity with reference to LBOs is addressed by the Italian Tax Authority in Circular No. 6/E of 30 March 2016. The circular takes a narrower approach than that taken in the decision under discussion and establishes the following.

In summary the Authority stated that:

"*In principle, interest expenses related to loans taken out by an SPV to purchase securities are functional to acquiring the target company […] [and, therefore] entities* *subject to corporate tax (IRES) […], should be considered, in principle, as satisfying the test and, thus, as deductible to the extent permitted by Art. 96".*

It is thus clear that the Italian Tax Authority:

- holds that an assessment of the connection between interest expenses and the business activity is generally required to establish deductability; and
- acknowledges, with reference to LBOs, the connection between interest expenses and the business activity, albeit not in absolute terms (as the use of "in principle" is ambiguous).

Against this backdrop, the decision enables one to **face and resolve the root of the issue**: It **establishes that interest expenses are deductible regardless of an assessment on the connection to the business activity**. The decision also erases any doubts that the circular – which acknowledges the connection to business activity only "in principle" – may have raised in private equity operators.

3. LBOs and abuse of law

The decision seems to protect newcos (and/or the company resulting from a merger between a newco and the target) from future denials of deductability based on a lack of connection between the interest expenses and the business activity. But **the same cannot be said for objections based on abuse of law.**

Abuse of law is not addressed in the decision but is in the circular: The Italian Tax Authority maintains that, as LBOs respond to non-tax-related needs, "they should not be considered as essentially pursuing undue tax advantages", except when "other **specific indicators of an artificial transaction** are found […], **such as when the shareholders that directly or indirectly control the target company participate in the LBO**" [emphasis added].

Even though this aspect is crucial, the circular **fails to precisely define transactions that** – in the Italian Tax Authority's view – are artificial.

Nonetheless, based on the reference to "the shareholders that directly or indirectly control the target company" (although given as an example), it seems reasonable to assume that the Italian Tax Authority intended to refer to cases in which an LBO does not result in **a change of control.**

Possible examples …

(a) The transaction results in a change of control of the target company

Based on the foregoing, an artificial transaction should not be found when the target's pre-existing controlling shareholders participate in the transaction (by reinvesting in the newco), **provided that the transaction results in a change of control of the target company**. Thus no finding of an articial transaction when the pre-existing shareholders' interest changes: (a) from a controlling interest (individual or joint) to a minority interest; (b) from individual control to joint control; or (c) from joint control to individual control.

(b) The transaction results in one or more pre-existing minority shareholders acquiring control of the target

These transactions should be equally lawful (given that the circular refers only to shareholders initially in a position of control).

(c) Transactions without a change of control

Based on the circular, greater caution should be taken with LBOs within a business group that do not entail a change of control, when the result is, for example, the reallocation of a company within the group. In these cases, the Italian Tax Authority might still question the purposes of streamlining or reorganisation that likely led to the transaction and find that the transaction was carried out to pursue an "undue tax advantage". It could thereby deny deduction of the interest expenses (regardless of their connection to the business activity).

However, there are founded defence arguments even for the above cases.

… and defence strategies: absence of undue tax advantage

Under the legislative notion of abuse (Art. 10-bis of Law No. 212/2000) it is first necessary that the transaction (executed by a taxpayer) leads to a **tax advantage** that is contrary to the "rationale or general principles of tax law" and, accordingly, **is *undue***.

It is difficult to ascertain what tax law or principle is "abused" in transactions that the Italian Tax Authority considers artificial.

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In fact as far back as 2013, the Supreme Court excludes (Decision No. 24434/2013) the possibility of invoking abuse of the principle of "connection with business activity" and states that instead a violation of the law that sets forth this principle should be found (Art. 109(5) of the TUIR).

The absence of a law or principle being "abused" appears more evident in light of the Decision No. 19430 of 20 July: The Court excludes the existence of limits and conditions on the deductibility of interest expenses for limited companies other than those under Art. 96 of the TUIR (i.e., 30% of EBITDA).

In any case, even assuming the existence of an undue tax advantage, the current anti-tax avoidance law applies only when certain additional requirements are all met (i.e., the transaction lacks economic substance and the tax advantage is regarded as essential to the transaction). It should be possible to maintain that most private equity transactions do not meet these requirements given that – as they consist of a fund investing to develop a business by providing management and know-how – they are clearly aimed at business not tax-related purposes.

And even when all the above requirements are met, a transaction should still not be considered abusive if it is justified by "valid, non-tax related purposes of a non-marginal nature, such as organisational and managerial purposes, which respond to the need of improving a company's structure or operation".

4. Conclusion

The issue is very delicate and requires a case-by-case analysis. However, in light of the foregoing, a tax avoidance finding may be found in **LBOs that are clearly "circular", with the sole purpose of creating interest expense deductions without any real change in the shareholding structure**. That said, these types of transactions are generally uncommon in the private equity world.