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Recent Legislation on the Tax Regime Applicable to "Carried Interest"

This contribution describes article 60 of Law Decree No. 50 of 24 April 2017, which clarifies the regime applicable to "carried interest" compensation granted to managers and/or employees.

1. Introduction

Carried interest is a form of compensation granted to managers and/or employees by way of a non-proportional allocation of shares, quotas or financial instruments that include enhanced economic rights ("Instruments"), aimed at aligning the interests of the recipients with that of the investors.[1]

Article 60 of the Law Decree of 24 April 2017 No. 50 ("Article 60")[2] sets out the conditions under which the proceeds of a carried interest ("Proceeds") paid to managers or employees of certain entities must be qualified as income from capital ("Financial Income"). Where such conditions are not met, the Proceeds may be recaptured under the category of "employment" or "self-employment income" (referred to collectively herein as "Employment Income").

The new legislation has been favourably received, as it draws a line that helps practitioners appropriately categorize the Proceeds.

Before this provision was enacted, it was unclear[3] whether the Proceeds were subject to the regime applicable to Employment Income and taxed at progressive rates up to 43% plus local surcharges or could be subject to the flat tax rate of 26%, generally applicable to Financial Income.

This uncertainty was the consequence of a specific set of provisions that tended to view any form of remuneration (in cash or in kind) received in relation to the employment relationship as Employment Income.[4]

Due to the lack of guidelines clarifying when the Proceeds were to be qualified as remuneration connected to being a co-investor, it was difficult to exclude the possibility of the income being akin to a kind of performance fee that, in the hands of managers/employees, should be seen as remuneration paid in relation to an employment activity.

Article 60 now states that Proceeds received by resident or non-resident managers and employees must be qualified as Financial Income by way of an irrebuttable presumption of law, provided the following three conditions are cumulatively fulfilled:

- the investment of the managers/employees is at least equal to 1% of the net equity of the relevant company/other entity or of the investment of the collective investment vehicle (the "Investment Threshold");
- the Proceeds are distributed only after all other shareholders or investors have received a return equal to the invested capital plus the agreed hurdle rate ("Subordination of the Proceeds"); and
- the interest that entitles the managers/employees to the Proceeds is held for an uninterrupted period of at least 5 years ("Holding Period").

If such conditions are not met (in full or in part), a case-by-case analysis is necessary to ascertain which category the Proceeds fall under (Financial Income or Employment Income).

Consequently, where one or more of the conditions outlined are not met, this does not mean conclusively that the Proceeds will be qualified as Employment Income. They might still benefit from the Financial Income qualification if, for example, an actual investment risk is borne by the managers/employees or the effect of the carried interest is to align the position of the latter with that of the investors. In the event of doubt, it is possible to request a ruling confirming the tax treatment of the Proceeds.

The Italian tax authorities, in Circular Letter No. 25/E of 16 October 2017 ("the Circular"), comment on article 60. The Circular details the scope of application of the provision and the conditions that must be met in order for the Proceeds to be qualified as Financial Income.

2. Scope of Application of Article 60

2.1. Eligible managers/employees

In general, the managers and employees who may benefit from the regime must have an employment relationship

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1. The carried interest regime analysed in this note refers specifically to proceeds payable as a consequence of the holding of the Instruments. In contrast, the assignment of such Instruments triggers a different taxable event according to which the difference between the fair market value of the Instruments and the amount paid for their acquisition is characterized as employment or self-employment income, taxable at the applicable progressive income tax rates in the hands of the managers/employees.
2. IT: Law Decree of 24 April 2017, No. 50, converted into the Law of 21 June 2017, No. 96, entered into force on 24 Apr. 2017. It applies to proceeds paid out as of this date.
3. The uncertainty was not resolved by the Italian tax authorities, who have commented on this issue by way of certain resolutions. Amongst others, *see* Resolution No. 29/E of 16 Feb. 2006 and Resolution No. 103/E of 4 Dec. 2012.
4. IT: Income Tax Consolidation Act, Presidential Decree No. 917/1986 (*Testo Unico delle Imposte sui Redditi*), arts. 50 and 51, National Legislation IBFD, includes any said remuneration in employment income; art. 53 is the self-employment income category.

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with the company,[5] entity or management company of the collective investment vehicle that issued the shares, quotas or financial instruments that include enhanced economic rights.

The issuing entities may also be resident outside of Italy subject to the proviso that they be resident in countries that allow for an adequate exchange of information with Italy.[6]

In addition, the Circular widens the scope of application of article 60 by also including managers and employees of the advisory companies that may be involved in the transaction generating the carried interest (generally a private equity or venture capital deal). By contrast, professionals, such as lawyers, accountants, etc. are excluded.

Instruments also fall under the scope of article 60 if they are held via a company that the managers/employees participate in.

2.2. Conditions for the Proceeds to be qualified as Financial Income

2.2.1. Investment threshold

In order for the interest of managers/employees to be aligned with that of investors, article 60 requires that the financial investment of all of the managers/employees who are granted Instruments be equal to at least 1% of the investment of the collective investment vehicle or of the net equity of the relevant company/entity.

With reference to the latter, the net equity must be computed at fair market value and must be certified by an expert's appraisal.

For the purpose of calculating the 1% threshold, any financial investment made by managers/employees in shares, quotas or other instruments that do not include enhanced economic rights may also be taken into account (held by the same managers/employees who were granted the Instruments), as well as any amount subject to ordinary taxation as Employment Income upon an assignment of the Instruments.[7]

The investment of the managers/employees must be actual and expose the holders to financial risk in terms of monetary loss.

As far as collective investment vehicles are concerned, the investment threshold must be calculated having regard to the total commitment of the vehicle upon the expiration of the subscription period. Subsequently, this amount (the total commitment) must be compared with the drawdowns of the vehicle (net of debt raised by the vehicle) in order to ascertain whether the investment threshold is met.

With regard to companies, the investment threshold must be adjusted in light of new subscriptions of capital (by old or new investors) within the statutory year during which the investments were completed in order to avoid the percentage falling below the minimum threshold.

2.2.2. Subordination of the Proceeds

The Proceeds may be qualified as Financial Income if they are distributed only after the capital invested by all existing investors or shareholders has been reimbursed and the envisaged minimum return on the investment has been received (i.e. the "hurdle rate" agreed to in the statutory document or regulations).

This condition applies in respect of the Proceeds only, i.e. the "extra return" recognized as a consequence of the enhanced economic rights that characterize the Instruments. Therefore, the legal presumption that qualifies the Proceeds as Financial Income is not affected in the event of a reimbursement of capital or payment of ordinary proceeds to the managers/employees (such as dividends paid in relation to the shares or quotas held by them).

Whilst the condition at hand is in line with the purpose of aligning the interests of the managers/employees with those of the investors when the investment is in collective investment vehicles or investment companies, it becomes difficult to meet when the issuing entities are family businesses, family companies or other entities the participants of which may have a long-term financial view.

In such a scenario, it is unlikely that the participants will want their invested capital reimbursed shortly after the expiration of the Investment Period. This may present a serious obstacle to managers/employees wanting to benefit from the Financial Income qualification.

3. Holding Period

The minimum Holding Period is 5 years commencing on the subscription dates described in section 2.2.1. The condition must be fulfilled with regard to Instruments, as well as shares, quotas or other instruments not associated with enhanced economic rights, held by eligible managers/employees, that cumulatively meet the investment threshold.

This condition may also be met in the event that the Instruments are owned by heirs as a consequence of a succession event regarding managers/employees. In such a scenario, the 5-year period must be computed taking into account the holding period of the latter, together with that of their heirs.

The holding period may be derogated from in the event of a change in control of the relevant companies or a change in the entity in charge of management of the collective investment fund. For example, this is the case when the managers/employees sell the Instruments as a consequence of a reorganization involving the issuing company.

In order to benefit from the Financial Income qualification, the Proceeds may also be distributed before the 5-year period elapses provided the Instruments are held for at least the minimum Holding Period.

5. As far as companies are concerned, they can be both the one that makes the investment and the target company.
6. IT: Ministerial Decree of 4 Sept. 1996 provides for a list of qualifying non-resident countries (the whitelisted jurisdictions).
7. *See supra* n. 1.

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