GPB L&P

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Foreign private equity funds: an actual victory for the future and a Pyrrhic victory for the past?

Italian investment funds are fully exempt from taxes. Foreign investment funds are fully liable to taxes in Italy. Is this discriminatory? The question is supposed to answer itself but in tax matters mere suppositions are often wrong. This is especially true for European private equity funds that, even in these days, are subject to heavy scrutiny by Italian tax authorities with respect to capital gains arising from the disposal of their Italian investments. The draft Budget law seems to put a full stop on this but only for the future: would it be a Pyrrhic victory for past years?

The tax regime of Italian investment funds

Italian investment funds are regarded as opaque taxable persons from an Italian tax perspective. Although potentially liable to corporate income tax, they are fully exempt from it. This applies to all funds established in Italy, either regulated under the UCITS Directive or falling within the scope of the AIFM Directive. Distributions made by the funds

are subject to Italian tax, unless the investors are resident in white listed States or are qualified institutional investors. This implies that Italian source income and gains realized by the Italian funds are exempt from any taxes in Italy if the investors qualify for the exemption.

The current tax regime of foreign investment funds

Foreign investment funds do not enjoy from any special tax status. They are regarded as regular non-resident taxpayers. This means that dividends distributed to them by Italian resident companies are subject to dividend withholding tax and Italian source capital gains realized by the funds are subject to tax in Italy unless they refer to the so called "non-qualified shareholdings" (representing no more than 20% of voting rights or 25% of share capital. The percentages fall to 2% and 5% respectively in case of listed companies).

The use of SPVs in private equity acquisitions

Most of private equity funds make their own investments not directly but through special purpose vehicles (SPVs). This holds true also for Italian funds who are exempt from taxes anyway. The use of the SPVs may even determine a higher taxation for them but, evidently, SPVs serve relevant non-tax purposes (governance, guarantees on financing, guarantees upon exit, etc.).

With respect to foreign investment funds, tax audits tend to disregard the SPVs through which the Italian investments are made. In most cases, SPVs are companies resident in a treaty country, are managed there, are entitled to treaty protection but nonetheless are considered as abusive schemes established by the foreign funds to avoid paying Italian taxes on Italian source income. Income or gains formally realized by the SPVs are imputed to the funds themselves and the individuals leading the relevant management company are potential liable to criminal tax penalties in Italy.

It seems like a sort of "squared discrimination": first because foreign funds are liable to taxes that Italian funds would not had been subject to. Second because they are deemed to establish SPVs mainly for tax reasons and not for the very non-tax reasons that move Italian funds.

A red light from the draft Budget Law

The draft Budget Law seems to go in the right direction, clarifying that foreign funds should not pay Italian taxes on any Italian source dividends or capital gains. May be, but hopefully not, future scrutiny will turn in saying that SPVs cannot be disregarded but are deemed to be resident of Italy or to maintain a permanent establishment in the territory of the State.

However, what looks like a real victory for the future risks to be a Pyrrhic victory for the past. Indeed, the draft law states that it will only apply for the future. It is clear the intent to avoid a flood of refund requests, especially from UCITS funds, but would it mean that audits can keep going for past years? Optimism should prevail but a prudent dose of realism should recommend to keep the shields tight.

And what about non-EU funds and real estate funds?

The draft legislation does not apply to non-EU funds which in principle remain subject to Italian taxation despite the EU Treaty would prevent restrictions to the movement of capital also with respect to non-EU investors. Similarly, it does not apply to foreign real estate funds but for them the discrimination is as evident as for the other funds.
The recommendation is to be patient and wait. The road to Europe is still paved with good intentions!