CLEARY GOTTLIEB

ALERT MEMORANDUM

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Italy's New Rules to Facilitate Direct Lending

On June 24, 2014, the Italian Government adopted Law Decree no. 91 (the "Decree")[1] that, among other things, introduced various measures aimed at stimulating the Italian economy[2].

This memorandum outlines some of the measures contained in the Decree designed to increase the availability of non-bank debt financing to Italian companies and lifting certain tax obstacles to the access by non-listed companies to the international debt capital markets.

I. Regulatory Changes

Lending Deregulation

In Italy lending activity (including issuance of guarantees) has been traditionally reserved to banks and those financial intermediaries enrolled in a specific register held by the Bank of Italy that are subject to regulatory and prudential provisions broadly mirroring those applicable to banks (the "106 Intermediaries").[3]

In order to facilitate Italian companies' access to non-bank debt financing, the Decree expanded the scope of the entities that are allowed to carry out lending in Italy by including Italian insurance companies and Italian securitization vehicles ("Securitization SPVs").[4]

Insurance Companies

With respect to insurance companies, the Decree directly amends Art. 106 of the Italian Banking Act in order to add a specific carve-out from the general prohibition on lending activity for any lending (other than the issuance of guarantees) carried out by Italian insurance

[1] The Decree was published in the Official Gazette on June 25, 2014, date as of which it is effective. It will have to be converted into law by Parliament within 60 days, otherwise it will lapse on a retroactive basis. Amendments to the Decree could be passed during the conversion process.

[2] For a description of the reform enacted with the Law Decree December 13, 2013, please see our alert memo dated December 18, 2013, available at http://www.cgsh.com/italys-new-rules-to-foster-access-to-medium-long-term-financing/

[3] See Art. 106 and ff. of Legislative Decree No. 385 of September 1, 1993 (the "Italian Banking Act").

[4] Securitization SPVs are established under Art. 3 of Law No. 130 of April 30, 1999 (the "Securitization Law").

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companies other than to natural persons and so-called micro-enterprises (as defined by EU Commission Recommendation 2003/361/EC)[5].

The regime applicable to the abovementioned lending activity will be specified by implementing regulations to be issued by the competent authorities. Specifically, the Italian banking regulator (Banca d'Italia) has been given authority to identify the reporting requirements applicable to Insurance companies engaged in lending as well as the manner of their inclusion in the Italian centralized credit risk database (*Centrale dei rischi*). Similarly, the Italian insurance regulator (IVASS) has been authorized to establish limits and conditions applicable to such lending by insurance companies in accordance with the following principles:

- borrowers will be selected by a bank or a 106 Intermediary; such entities should "*retain a significant economic interest in the transaction*";

- the insurance company will be adequately capitalized and have an internal control and risk management system which allows the insurance company to manage the risks typically related to the lending activity.

<u>Securitization SPVs</u>

The Decree also contains provisions enabling Securitization SPVs to carry out lending in Italy, other than *vis-à-vis* natural persons or "micro-enterprises".[6] [7]

The Decree further specifies the conditions applicable to such lending by Securitization SPVs. Like for insurance companies, banks or 106 Intermediaries must select the borrowers and retain a "significant interest" in the transaction. In addition, the Decree provides that the securities issued to finance such lending may be purchased only by "qualified investors".[8]

It is not clear whether the restriction on identity of the initial purchasers also entails a restriction on re-sales to entities other than qualified investors.

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[5] Under Art. 2.3 of the Annex to the Recommendation, micro enterprise is defined as an enterprise which employs fewer than 10 people and whose annual turnover and/or annual balance sheet total does not exceed EUR 2 million.

[6] Unlike with respect to insurance companies, the Decree does not carve-out the issuance of the guarantee and, as a result, Securitization SPVs would appear to be allowed to issue guarantees.

[7] Somewhat confusingly, instead of introducing a further carve-out in Art. 106 of the Italian Banking Act, where the general prohibition is contained, the Decree amends the Securitization Law to provides that Securitization SPVs are allowed to carry such lending. Although the illustrative report (*relazione illustrativa*) accompanying the Decree clarifies that such a change is designed to extend to securitization vehicles the ability to act as direct lenders, the fact that Art. 106 of the Italian Banking Act was not amended to permit this could give rise to interpretative issues in the future.

[8] The definition of "qualified investor" mirrors that of "professional client" provided for under the MiFID regime and includes, among others, banks, investment firms, insurance companies, collective investment undertakings, pension funds, broker dealers and other institutional investors as well as large corporations.

II. Tax Measures

The tax measures introduced under the Decree, among others, (i) amend and broaden the scope of the substitute tax regime (described below) applicable to medium/long-term bank financing pursuant Articles 15 and ff. of Presidential Decree No. 601 of September 29, 1973 (the "Substitute Tax Regime"), (ii) introduce a withholding tax exemption on interest paid on Medium-Long Term Debt held by certain foreign lenders, and (iii) extend certain withholding tax exemptions to issuances of certain non-listed debt securities (*e.g.* bonds and commercial paper) issued by non-listed companies.

Amendment of the Subjective and Objective Scope of Application the Substitute Tax Regime[9]

By way of background, certain documentary taxes, which can be material depending on the terms and structure of the transaction, apply to the execution of financing documents in Italy. The Substitute Tax Regime allows a borrower to opt to pay a 0.25% tax on the principal amount of the financing *in lieu* of all transactional taxes that would otherwise be applicable to the execution of the finance documentation (including any security documents) if the financing has a maturity exceeding 18 months ("Medium-Long Term Debt"). This option was until now only available if the lender is an Italian bank pursuant to the Italian Banking Act, an Italian authorized permanent establishment of a foreign bank, EU or non-EU, an EU bank or the financing is in the form of a bond. [10]

Consistently with the deregulation spirit described above, the Decree broadens the list of entities that are eligible for such Substitute Tax Regime to include Securitization SPVs, insurance companies and collective investments undertakings established in a EU Member State or in a State that is part of the European Economic Area included in the list of States and territories allowing an adequate exchange of information with the Italian tax authorities ("White Listed Countries").

Moreover, the Decree broadens the Substitute Tax Regime's to transfers of the participation in the financing that benefited from the regime, of the relating receivables and related security interest. As a result, trading in secured loans or debt securities should no longer give rise to additional transactional tax costs.

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9 See Article 22, paragraph 2, of the Decree.

10 More specifically, the Substitute Tax Regime is an optional regime that, before the amendments enacted with the Decree, applied to loans, and their relating security package, (i) extended by qualified financial institutions, (ii) having a maturity exceeding eighteen months, and (iii) executed in Italy, in lieu of all transactional taxes ordinarily applicable thereto. As a result of a recent prior change, the regime already applied to bond issuance also having a maturity of more than eighteen months. Whenever the ordinary regime would entail a transactional tax cost in excess of 25 bps, *i.e.* the rate at which the substitute tax is currently applicable, the Substitute Tax Regime is clearly advantageous. Otherwise (*i.e.* whenever the loan/bonds issuance and related security package would be subject to nominal taxes), the substitute tax would ultimately result in an increased cost of the financing. The optionality of Substitute Tax Regime enables the borrower to choose and, hence, to assess in advance whether such regime is in fact advantageous.

Withholding Tax Exemption on Interest Income Earned by Certain Foreign Lenders[11]

Under Italian tax rules, interest paid on loans is generally subject to a 20% withholding tax (26% for interest accruing from July 1, 2014). [12]

The Decree introduced an exemption from such withholding tax for interest paid by Italian borrowers on loans that are Medium-Long Term Debt to the following foreign categories of creditors: (i) financial institutions established in a EU Member State, (ii) insurance companies established and authorized under the law of a EU Member State, (iii) collective investment undertakings that do not make use of financial leverage, including tax transparent entities, set up in a White Listed Countries.

Withholding Tax Exemption on Interest Income Earned on Non-listed Debt Securities by Certain Foreign Investors[13]

Under Italian tax rules, interest paid on debt securities are generally subject to a 20% substitute tax (26% for interest accruing from July 1, 2014).

Under previous tax law, interest earned on any debt securities issued by banks and listed corporations and listed debt securities issued by any other entities were exempt from such substitute tax provided that (i) the beneficial holders of such securities are resident in White Listed Countries and (ii) such holders comply with certain standard certification procedures.

The Decree extended this exemption to non-listed debt securities issued by non-listed issuers so long as they are held only by qualified investors. [14]

Furthermore, the Decree also contemplated that in the event that the co-investors in the debt securities described above are both EU collective investment undertakings and/or Securitization SPVs and other investors that do not qualify as qualified investors, such exemption on interest paid to EU collective investment undertakings and/or Securitization SPVs applies provided that (i) more than 50% of their assets consist of the debt securities mentioned above and (ii) their investors are solely qualified investors. These requirements must be set out in the collective undertakings governing documents.

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[11] See Article 22, paragraph 1, of the Decree.

[12] The domestic rate may be reduced pursuant to the convention against double taxation applicable to the relevant recipient. An Italian withholding agent (*e.g.*, the Italian borrower) applies the reduced treaty rates insofar as the recipient (i) is liable to tax in the State of residence, and (ii) qualifies as the beneficial owner of the income received (*e.g.*, interest) and complies with certain standard certification procedures. There is no domestic statutory rule that defines the notion of beneficial ownership. However, the recipient of such an income stream must have to be viewed to be not only the legal but also the economic owners of such payments (some powers which render it, in relation to the income concerned, not to be viewed as a mere fiduciary or administrator acting on account of the interested parties).

[13] See Article 21 of the Decree.

[14] See footnote 8 above.

This is an important development as it enables non-listed companies to further access international capital markets without having to bear the cost of a listing or, alternatively, of a tax gross-up which would increase the cost of the financing.

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