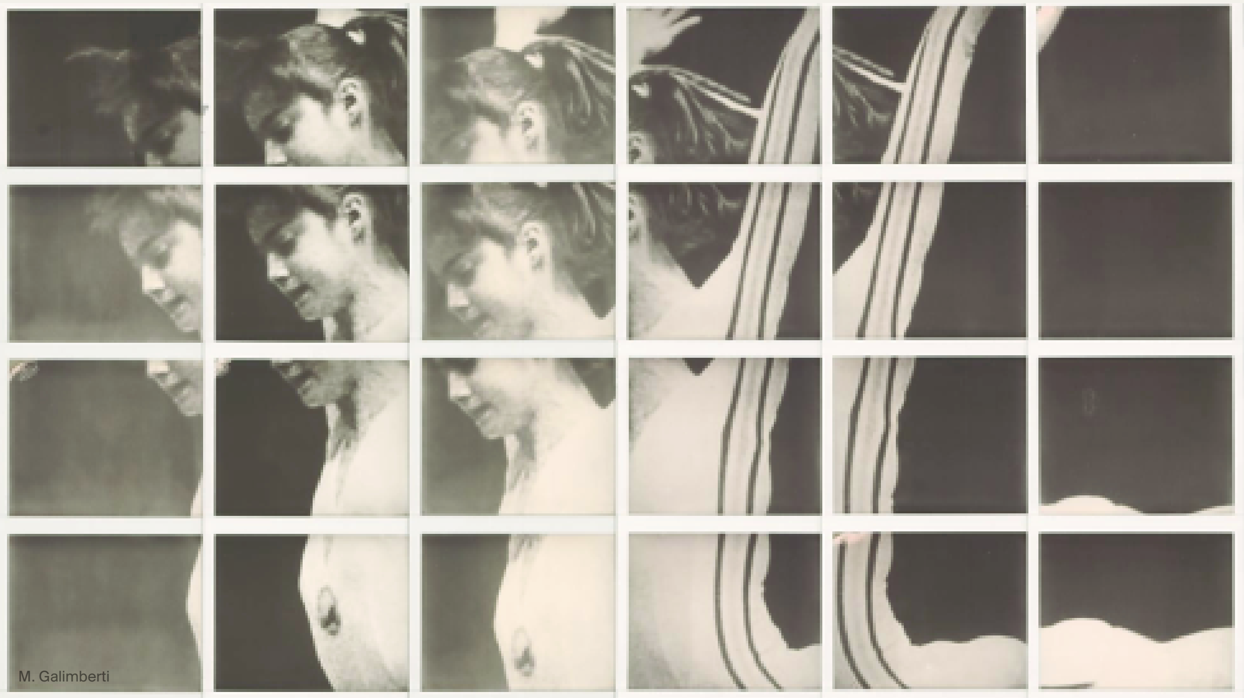
GattiPavesiBianchiLudovici



CORPORATE TAX AND M&A

Italian revenue agency tightens up the rules on taxation of revaluation reserves in mergers

The draft circular letter published for comments by the Italian Revenue Agency on November 23, 2021 may have a negative impact on the completion of mergers with companies showing tax suspended reserves in their balance sheet arising from the optional revaluation (or step-up in value) of assets for tax purposes.

Background

Over the last 40 years, many companies opted for the revaluation of their assets for both balance sheet and tax purposes ("revaluation of assets") or for the step-up of the tax basis of these assets to align it to their (higher) accounting value ("step-up of the tax basis of assets"). These optional regimes were provided by various laws enacted over time. From year 2000 on, these regimes consistently made reference to the archetype provided by Law n. 342 of 2000 (the "**Law**").

According to the Law, the recognition for tax purposes of the higher values of the assets is subject to the payment of a substitute tax at favourable tax rates. In addition, Article 13 and 14 of the Law provide certain rules with regard to the treatment of the balance resulting from the revaluation or step-up (this balance being equal to the difference between the increase in the tax basis of the assets and the substitute tax paid).

Specifically:

– Article 13 paras 1 and 2 provide the rules applicable to the balance arising from the revaluation of assets from a **corporate law** and balance sheet perspective. In this respect, Para

1 provides that this balance "*must be allocated to the share capital or to a special reserve designated with reference to this law, with exclusion of any different utilization*". Partially derogating to the provision of para 1, para 2 allows the balance to be used for covering losses, as follows: "*If the reserve is not allocated to the share capital, it can be reduced only in compliance with the provisions of the second and third paragraphs of article 2445 of the civil code. In case of use of the reserve for covering losses, no profit distribution can be made until the reserve is replenished or reduced correspondingly with a resolution of the extraordinary [shareholders'] meeting, without application of the provisions of the second and third paragraphs of article 2445 of the civil code*".

- Article 13 para 3, instead, provides the **tax regime** of the balance arising from the revaluation of assets. Specifically:
  - *i.* it provides that the "special reserve" to which the balance is allocated qualifies as a tax-suspended reserve, i.e. a reserve that becomes taxable (in the hands of both the company and the shareholders) only if and when a specific event identified by the Law occurs; and
  - *ii.* it identifies the specific event triggering the taxation of the reserve - the distribution of such reserve to the shareholders - as follows: "*if the balance is attributed to shareholders ... by means of the reduction of the reserve ... or by reducing the share capital ..., the sums thus attributed to shareholders ..., increased by the substitute tax corresponding to the amount distributed, are included in the taxable income of the company and in the taxable income of the shareholders or participants*".
- Finally, Article 14 para 2 of the Law extends the applicability of the tax regime of the balance set forth for by Article 13 para 3 of the Law also to the balance arising from the step-up of the tax basis of the assets.

Based on the wording of Article 13, para 3 of the Law and based on past practice of the Italian Tax Authorities (see, in particular, ministerial resolution n. 1/2001), there was a common understanding that the "special (tax-suspended) reserve" would be taxable only in the event of its distribution to shareholders.

This common understanding was particularly relevant in the context of MLBO transaction and, more in general, of mergers of companies.

Indeed, Article 172 para 5 of the Presidential Decree 22 dicembre 1986, n. 917 (Italian Income Tax Act – "**ICTA**") provides that the tax-suspended reserves qualifying as "*taxable only in the event of distribution*" survive in the equity of the merging entity only "*if and to the extent there is a merger surplus*" or (assuming for the sake of simplicity the example of merger of 100% owned companies) in case the merger leads to a "*share capital increase*". Therefore, based on the understanding that the special reserve at stake fell into the category of the reserves "taxable only in case of distribution" and that a merger cannot be considered as a way to attribute the reserve to the shareholders of the merging companies, these companies always considered that if the merger gives rise to a merger deficit (instead of a merger surplus) and does not entail any share capital increase, the revaluation (or step-up) that was booked in the equity of the merged company would simply disappear upon the merger without triggering any taxation nor should be reinstated in the merging company equity.

The following example could help to better understand the subject matter:

- BidCo has net equity reserves of Euro 2,000 and financial debts for 8,000. Bidco acquires the 100% of Target for a purchase price of Euro 10,000.
- Target's net equity equals to Euro 6,000, of which Euro 5,000 is a revaluation reserve;
- After the acquisition, Target is merged into Bidco by means of a direct merger. As a consequence thereof, BidCo incurs a merger deficit (s.c. "*disavanzo da annullamento*") of Euro 4,000 (10,000-6,000) that is allocated to the Target's assets or to goodwill;

Step 1 - Acquisition of Target

BidCo

Target	10.000	2.000	Net equity
		8.000	Debts
TOT	***10.000***	***10.000***	***TOT***

Target

Assets	7.000	6.000	Net equity (of which: 5.000 tax suspended reserve)
		1.000	Debts
TOT	***7.000***	***7.000***	***TOT***

Step 2 - Direct merger of Target in BidCo and registration of merger difference

BidCo

Target	10.000	2.000	Net equity
Assets	7.000	9.000	Debts
		6.000	Merger difference
TOT	***17.000***	***17.000***	***TOT***

Step 3 - Cancellation of participation in Target and registration of merger deficit

BidCo

Merger deficit	4.000	2.000	Net equity
Assets	7.000	9.000	Debts
TOT	***11.000***	***11.000***	***TOT***

— Based on the common understanding and practice before the publication of the draft circular letter, in the above example the revaluation reserve (5,000) would disappear without triggering any taxation in the hands of BidCo, pursuant to Article 172 para 5 of the ICTA. Hence, since the reserve is taxable only in case of distribution to shareholders (which does not occur in the merger) and since the merger does not lead to any merger surplus nor to any increase of share capital, the equity of the merged company, including the tax-suspended reserve, does not "survive" in the equity of the merging company.

What the draft circular letter says

The draft circular letter states that the tax-suspended revaluation reserve "*does not fall into the category of the reserves that are taxable only in the event of distribution*" for the purposes of the application of Article 172 para 5 of the ICTA (for the case of mergers) and Article 173, para 9 of the ICTA (for the case of demergers). As a consequence thereof, according to the Tax Authorities, the beneficiary company of a merger (but the same conclusion can be applied to the merging company, in the case of a merger) "*must reinstate the tax-suspended reserve by allocating it to its available reserves* [in its balance sheet] *... and share capital* [in the notes to its financial statements]*"*, while *"the portion of the reserve that cannot be so reinstated due to the lack of available reserves or share capital will be taxable*".

If one applies the interpretation brought forward by the draft circular letter to the example proposed above, the consequences would be the following:

- despite the merger does not lead to any merger surplus nor to any increase in share capital of Bidco, the tax-suspended revaluation reserve booked in the balance sheet of Target would not simply disappear without triggering taxation. Instead, this reserve should be allocated to the net equity of Bidco after merger up to the maximum possible extent (i.e. 2,000, in the example);
- the portion of revaluation reserve that cannot be allocated to net equity of the merging company (i.e., difference between the revaluation reserve of Euro 5,000 and the net equity of BidCo of Euro 2,000) would be subject to tax in the hands of the latter company, triggering a corporate income tax of Euro 3.000 * 24%.

The same consequences, according to the draft circular letter, would apply to the tax suspended reserve arising from the step-up of the tax basis of the assets.

The tax authorities deny the qualification of the tax-suspended revaluation reserve (or step-up reserve) as a reserve that are taxable only in the event of distribution, based on the application of the provisions set forth by Article 13 paras 1 and 2 of the Law, which refer to the admissible utilizations of this reserve for corporate law purposes. Specifically, the position of the Tax Authorities is based on the following argument: "*From a tax perspective, any utilization of this reserve for purposes other than those provided for by the Law (i.e., utilization for covering losses or reduction pursuant to Article 2445 of the Italian Civil Code) triggers the event for the taxation of the reserve itself*".

The interpretation of the draft circular letter does not come to a complete surprise. Indeed, the said interpretation was somehow anticipated by a recent unpublished ruling issued by the Italian Revenue Agency and mentioned by the specialized press and by the Association of Italian Joint Stock companies (Assonime, circular letter n. 18/2021). Moreover, it should be noted that the Italian Revenue Agency supports its conclusions in the draft circular letter by making reference to two precedents (which however were not as clear and direct as the draft circular letter in stating that the revaluation reserve "*does not fall into the category of the reserves that are taxable only in the event of distribution*", but) in which it maintained that the revaluation reserve should be taxable each time it is "*utilized for purposes other than those provided by the* [Article 13 paras 1 and 2 of the] *Law*". These two precedents are the resolution 32 of 1 March 2005 (which refers to the utilization of the revaluation reserve to offset the difference arising from the cancellation of the company's own shares) and the private letter ruling no. 316 of 2019 (which refers to the utilization of the balance arising from the revaluation to the direct accounting offsetting of a merger deficit). A similar conclusion was also reached (based on a quite contradictory line of reasoning) by the Italian Supreme Court in its decision n. 593 of 8 March 2017, according to which the reserve should be taxed when used to offset a merger deficit.

Why the position of the draft circular letter cannot be shared

The position of the draft circular letter is based on a wrong interpretation of Article 13 of the Law.
Indeed, the Tax Authorities derive the tax regime of the revaluation reserve from paras 1 and 2 of the said Article 13. As clearly emerges from the literal wording of the Law, however, these paragraphs do not minimally address the tax regime of the reserve but, as already mentioned above, they only provide the rules according to which the reserve can be utilized for corporate law and balance sheet purposes (i.e. allocation to the share capital or to a special reserve, utilization for covering losses or reduction of the reserve pursuant to Article 2445 of the Italian Civil Code).
On the other hand, the tax regime applicable to the reserve is provided exclusively by para 3, which qualifies the latter as a tax-suspended reserve and identifies one single specific event suitable to trigger the taxation of the reserve itself: the distribution of the said reserve to the shareholders.

Thus, contrary to the position of the draft circular letter:

i. it is not the cancellation of the reserve in itself (for purposes other than covering losses or the reduction according to Article 2445 of the Italian Civil Code) that leads to the taxation, but only the cancellation of the reserve caused by its distribution to the shareholders ("*is attributed to shareholders or participants by means of the reduction of the reserve...*)";

ii. the revaluation reserve and the step-up reserve can therefore certainly qualify as "*reserves that are taxable only in the event of distribution*";

iii. as a consequence thereof, when the merger does not lead to a (sufficient) merger surplus or share capital increase, the reserve is cancelled without triggering any taxation in the hands of the merging company, pursuant to Article 172, para 5 of the ICTA. The rationale is that the reserve has disappeared by effect of the merger without being distributed to the shareholders.

There are a number of additional arguments to counteract the position of the draft circular letter:

- if paras 1 and 2 were to regulate the events triggering the taxation of the reserve, there would be simply no need for para 3;
- Article 14 of Law 342/2000, when it extends the applicability of the tax regime of the revaluation reserve also to the balance arising from the step-up of the tax basis of the assets provides that such balance is "*subject to the regime provided by Article 13, paragraph 3*", without mentioning at all paras 1 and 2 of the same Article. Therefore, Article 14 indirectly confirms that the only event that determines the taxation of the reserve (no matter if it derives from a revaluation or a simple step-up of tax basis of the assets) is the one mentioned in para 3, i.e., the distribution of the latter to the shareholders;
- the explanatory report to Article 125 of the draft ICTA (now Article 172, para 5 ICTA) makes reference to the revaluation reserves governed by laws n. 576 of 1975 and n. 72 of 1983, which provide similar rules to those included in Article 13 of the Law and confirms that these reserves are "*taxable only in case of distribution*";
- all the circular letters issued by the Italian Tax Authorities with reference to the various laws enacted over time on the revaluation of assets always mentioned the "*distribution*" of the reserve provided by Article 13, para 3 of Law as the only event triggering the taxation of the reserve itself (see circular letters n. 207/E of 2000; n. 57/E of 2002; n. 11/E of 2009; n. 13/E of 2014; n. 14/E of 2017);
- the conclusion according to which a revaluation reserve booked in the balance sheet of the merged company qualifies as a tax-suspended reserve "*taxable only in case of distribution*" and is not taxable in case of merger leading to a merger deficit or to an insufficient merger surplus was expressly confirmed by the very same Italian Tax Authorities in the Ministerial Resolution n. 1/E of 11 January 2001. In addition, the Italian Revenue Agency reiterated its position according to which a revaluation reserve qualifies as a reserve "*taxable only in case of distribution (so called Type – 2 reserves)*" in the more recent ruling n. 27 of 2018, regarding a reverse merger;
- the same conclusion has always been shared by the unanimous doctrine and various associations, that firmly criticised the above mentioned precedents (in particular, the private letter ruling no. 316 of 2019 and the more recent unpublished rulings) in which the Italian Revenue Agency foreshadowed its new interpretation (see, among others: Italian Association of Joint Stock companies, - Assonime circular letters n. 6 and 18 of 2021; Italian Association of Chartered Accountants, rule of conduct n. 211 of April 2021);
- if the revaluation (and step-up) reserves were actually taxable as a consequence of events other than their distribution to the shareholders, the literal wording of the Law would be very different. Specifically, it would be in line with the wording utilized by other laws, regulating other categories of tax-suspended reserves. These laws expressly provide, for instance, that the reserve is taxable "*inasmuch it is utilized for purposes other than the setoff of losses*" (e.g. reserves regulated by the former Article 55 of the ICTA) or "*inasmuch it is anyhow utilized*" (for

instance, the reserves regulated by Article 33, para 9 of Law n. 413/91).

- the events leading to the taxation of a tax-suspended reserve can only be provided by the Law (namely, in the case at stake, by Article 13, para 3 of the Law). This principle has always been shared by the same Tax Authorities (see for instance circular letter n. 40/E of 13 May 2002, § 2.1). At the opposite, the final outcome of the draft Circular consists in the fact that the Tax Authorities are "creating" additional events for the taxation of the reserve (e.g. the disappearance of the reserve in case of absence of merger surplus), other than the specific event specifically provided by the Law (i.e., the distribution to the shareholders). This outcome clearly infringes Article 23 of the Italian Constitution, according to which "*No personal or patrimonial performance can be imposed except on the basis of the law*".

What can be done now?

In these days many commentators are criticizing the new interpretation brought forward by the draft circular letter from the Italian Tax Authorities. Nonetheless, it seems unlikely that the Revenue Agency will change its view in the final version of the circular letter (which is expected) to be published in the near future.

Since this new interpretation is not based on a change in law, in principle it should apply also to mergers completed in the past, unless the statute of limitations has already expired. It should be noted, in this respect, that based on Article 43 of the Presidential Decree n. 600 of 1973 the statute of limitations for mergers performed in 2016 (and for which the tax return was filed in 2017) expires on December 31st, 2021.

For instance, companies that in the past failed to tax a revaluation reserve in the context of a merger leading to a merger deficit are now exposed to a tax assessment by the Italian Tax Authorities. Even worse, the Tax Authorities could argue that the same consequences should apply even in those situations where the equity amount of the merging company would have been sufficient to reinstate the tax-suspended reserves of the merged company at the time of the merger in line with the new interpretation of the draft circular letter. In these situations, the taxation would be a consequence of the fact that the merging company simply did not reinstate the tax-suspended reserves in its balance sheet (or in the notes to the financial statements) related to the year in which the merger became effective, despite it could have so done if only it was aware of the new interpretation.

That being said, the question arises as to whether the Italian Tax Authorities can not only recover the unpaid taxes related to (the revaluation reserves that went untaxed in the context of) mergers declared in a tax return filed before the publication of the draft circular letter, but also apply tax penalties with regard to these mergers.

In principle, the taxpayer could avoid the application of penalties by invoking the principle of protection of trust set forth by Article 10, paragraph 2, of the Law n. 212/2000, according to which "*no penalties … are imposed on the taxpayer, if he has complied with the instructions contained in documents of the tax authorities, even if they are subsequently modified by the same authorities*". However, the Tax Authorities may try to counterargue that the principle of protection of trust does not apply at the case at stake since the interpretation contained in the draft circular letter of November 2021 is not new, but could be inferred from the mentioned precedents represented by resolution 32 of 1 March 2005, private letter ruling no. 316 of 2019 and Supreme Court decision n. 593 of 8 March 2017.

Nonetheless, there are other arguments to maintain that the penalties should not be applied. In this respect, based on various pieces of law (Article 8 of Legislative Decree n. 546 of 1992; Article 6, para 2 of Legislative Decree n. 472 of 1997; Article 10, para 3 of Law n. 212/2000) the tax penalties cannot be applied when the rule that is assumed to be violated is "objectively uncertain". According to the Supreme Court case law (among others, decision n. 4685 del 23 marzo 2012), this uncertainty may occur, among others, in those circumstances where there are "*difficulties in reconstructing the legal precept*" due to the unclear wording of the law or when there are "*conflicting administrative practices*".

Thus, even assuming, hypothetically, that the new interpretation of the Italian Tax Authorities could be shared, there would be sound arguments to maintain that in the case at stake the circumstances revealing the uncertainty of the law are present and that therefore the penalties should not apply. Indeed: (i) the interaction between Article 13 paras 1 and 2 of the Law (providing for the corporate law regime of the revaluation reserve) and Article 13 para 3 of the Law (which is the only provision explicitly referring to the tax regime of the revaluation reserve) would still be at least unclear; (ii) the Italian Tax Authorities have provided conflicting interpretations over time in realtion to the subject matter (in particular, Ministerial Resolution n. 1/E of 11 January 2001 and ruling n. 27 of 2018 clearly conflict with the interpretation provided in the draft circular letter, in the resolution 32 of 1 March 2005 and in the private letter ruling no. 316 of 2019).

As a matter of practice, in similar situations the Tax Authorities quite often apply penalties in their tax assessment disregarding the above rules. These penalties are sometimes subsequently cancelled by tax courts, even when they share the most recent interpretation of the tax Authorities.

Under a different perspective, how should the merging companies behave in the context of future merger transactions which, according to the new interpretation brought forward by the Italian Tax Authorities, would lead to the taxation of the revaluation and step-up reserves of the merged companies?

In principle, three main different approaches may be taken by the merging company in this respect:

1. first approach: the company disregards the interpretation provided by the Tax Authorities in the draft circular and appeals the deed of assessment that it will be notified in the future. In doing so, the company would rely on the opportunity to have the new interpretation brought forward by the tax Autorities subverted by the Court. The latter seems a quite risky approach. Indeed, should the company be unsuccessful in its tax controversy (which cannot be excluded, especially taking into consideration the decision n. 593 of 8 March 2017 that is substantially in line with the new interpretation from the Tax Authorities) it would be subject to the application of administrative penalties. In addition (at least in principle and provided that all the relevant conditions are met) criminal penalties may also apply.
2. second approach: the company bows to the new interpretation of the Tax Authorities. Therefore, it pays higher taxes in the context of the mergers of companies showing tax-suspended revaluation or step-up reserves, unless and until there will be an intervention of the lawmaker, a new change in the interpretation by the Tax Authorities or a settled case-law favourable to the taxpayers. Adopting this approach would not entail any risk in terms of administrative or criminal penalties but could be quite expensive;
3. third approach: a viable intermediate solution may consist of the following three-step approach:
    a. when filing the tax return related to the merger, the company adopts the new interpretation brought forward by the Tax Authorities. Therefore, it taxes the revaluation or step-up reserve that cannot be reinstated in its balance sheet due to the lack of available reserves or share capital;
    b. subsequently, the company asks for a refund of the higher tax paid as a consequence of the adoption of the (wrong) interpretation brought forward by the Italian Tax Authorities, pursuant to Article 38 of the Presidential Decree n. 602 of 1973 and based on the decision of the Supreme Court dated 16 July 2019, n. 19002;
    c. finally, the company appeals in front of Tax Court the (very likely) negative or omitted answer from the Italian Tax Authorities to its request of refund, pursuant to Article 19, para 1, of the Legislative Decree n. 546 of 1992. The related tax controversy may be a lenghty process but (if succesful) would give the taxpayer the opportunity to recover the higher tax paid and would not trigger any exposure to the application of tax penalties and criminal penalties.

Gatti Pavesi Bianchi Ludovici
Corporate Tax and M&A
Paolo Ludovici paolo.ludovici@gpblex.it
Andrea Prampolini andrea.prampolini@gpblex.it

GPBL

MILAN - ROME - LONDON

Home page | Highlights | Contacts | Linkedin