Dual income versus capitalization

Italy has introduced a dual income tax system, in the hope of overturning existing levels of capitalization. Paul Smith and Piergiorgio Valente of Ernst & Young, Milan, assess the benefits of the new system, and question the likelihood of a serious challenge to debt/equity policies

At the end of 1996, the Italian parliament authorized dramatic reform of the Italian taxation system through Law No 662/1996. Included in last year's tax reform was the mandate to reform the 37% corporate level IRPEG income tax regime through the introduction of a lower tax bracket available for new investments into Italy.

The dual income tax provisions are designed to boost economic activities by providing a tax incentive for companies to increase self-capitalization. It is hoped new investments and the retaining of earnings within the Italian company will alleviate the thin capitalization of many Italian entities. Italy has never introduced formal thin capitalization provisions.

The combination of introducing a new local tax (which does not permit an interest expense deduction for companies operating outside the banking and financial services industry), and the dual income tax benefits for equity contributions, is intended to change the historical capitalization levels of Italian operating companies. As the following analysis of the dual income tax framework reveals, this objective may prove exceptionally difficult to accomplish.

Conceptual approach and status of the dual income tax system

Article 3, §162 of Law No 662/96 contains the dual income tax system's general framework. A legislative decree white paper has recently been published by the government which provides detailed rules regarding how the dual tax rates should operate.

Computation of hypothetical return

Qualifying increase in net equity	X	Nominal return rate provided by the state	=	Tentative amount taxed at 19% rate

Based on the text of the new rules, the taxable base for the IRPEG tax system will be divided into two components. The first component will be an amount computed by multiplying any qualifying increases in the net equity of the enterprise by an average interest rate determined by referring to the financial returns of bonds listed on the Italian markets. This hypothetical return will be subject to a reduced 19% rate of IRPEG taxation (subject to limitations discussed below). The second tax base will equal all IRPEG taxable income for the year less the amount, if any, included in the first taxable base. This amount will be subject to tax under the historic 37% IRPEG regime.

To be a *qualifying* increase in net equity, the increase must be traced to specific items such as the contribution of money (not other property) or to actual earnings of the company. Increases in equity formed by transferring reserves to capital should not give rise to the benefits of the lower IRPEG tax rate. Similarly, contributions under an association in participation agreement are not expected to give rise to dual income tax benefits, as these are recorded as liabilities rather than as equity increases under Italian accounting rules.

The lower IRPEG tax rate benefits will be available for taxpayers in their first tax period beginning after the year in progress on September 30 1996. To calculate the qualifying increases, the net equity of a company at the end of its tax year is compared with the net equity at the end of the tax period in progress on September 30 1996. The necessary adjustments are then made to reduce the total increase in net equity by any non-qualifying items.

Because the net equity of each future tax period is compared with the net equity at the end of the year in progress on September 9 1996, a tax benefit can be realized for the year in which a qualifying increase in net equity occurs, and all later tax periods. (This assumes future losses, distributions or other items do not reduce the end of year equity below the September 30 1996 year-end level.)

International considerations

Consider the holding structure illustrated in Table 1.

If the qualifying equity increase and related dual income tax benefits were realized at the Italy 2 level due to a capital contribution by Italy 1, concern would be raised that the benefits may be only temporary in nature. According to Article 3, §162(i) of Law No 662/1996, the tax credit on dividend distributions is limited to the tax actually paid by the distributing com-

Table 1