

Tax Treatment of Italian Company Treasury Share or Bond Buy-Backs, and Convertible Bond Issues After Adoption of IAS/IFRS

By Roberto Egori

Roberto Egori explains the tax treatment of certain securities transactions for Italian companies that adopt the International Accounting Standards and International Financial Reporting Standards (IAS/IFRS).

1. Introduction

A number of Italian companies (e.g., banks, financial intermediaries¹ and companies whose shares are listed on a stock exchange) are currently required to prepare their financial statements according to International Accounting Standards and International Financial Reporting Standards (IAS/IFRS).² The 2008 Budget Law sets out certain specific tax provisions aimed at simplifying the income taxation of Italian companies that adopt ("Italian adopters of") IAS/IFRS.³ This article provides an introduction to the new tax regime, focusing on the application of these rules to selected financial transactions.

2. Income Taxation of Italian Adopters of IAS/IFRS: Basic Principles

Italian companies are normally liable for both corporate income tax (*Imposta sul Reddito delle Società*, IRES, currently levied at the rate of 27.5 percent) and regional tax (*Imposta Regionale sulle Attività Produttive*, IRAP, currently levied at the base rate of 3.9

percent, subject to possible regional surcharges). IRES and IRAP are governed by different legal provisions and are levied on different taxable bases, as briefly mentioned below.⁴

The IRES taxable income of Italian companies is determined from the pre-tax accounting profit (or loss) reflected in the income statements, as adjusted for specific tax provisions. As a result, the IRES taxable income is strongly dependent upon accounting.

Such an accounting dependency is even more pronounced with respect to IRAP. Indeed, the IRAP taxable income of Italian companies is determined based on the aggregation of certain lines of their income statements, with very limited required adjustments. The tax treatment of financial transactions for IRAP purposes is beyond the scope of this article, as it may vary considerably depending upon the industry in which the taxpayers operate.

Consolidated financial statements are not used for IRES and IRAP purposes. This is also true for Italian group companies taxed under the fiscal unit regime for IRES purposes; indeed, the overall taxable income of the fiscal unit is derived from the aggregation of the separate taxable incomes of the companies belonging to the fiscal unit.

These preliminary considerations explain why Italian corporate income taxes are normally said to follow accounting. Consequently, the Italian income

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tax consequences of a given transaction should be ascertained taking into account the relevant accounting treatment.

This aspect is even more true with respect to the determination of the IRES taxable income of Italian adopters of IAS/IFRS. Indeed, since 2008, Italian adopters of IAS/IFRS are subject to a specific tax provision whereby “the criteria as to the characterization, timing of accrual and classification in the financial statement provided by the mentioned accounting principles [IAS/IFRS] are respected [also for income tax purposes] and prevail over the [income tax] provisions”⁵ This provision was introduced by the 2008 Budget Law so as to align the IRES rules and IAS/IFRS and to make it easier for IAS/IFRS adopters to determine their taxable income. As further clarified by Decree 1 April 2009 no. 48 of the Ministry of Economy and Finance (the “IAS/IRES Decree”), the implications follow below:

- (1) The accounting treatment of transactions according to the substance over form principle under IAS/IFRS should be respected for income tax purposes.
- (2) Unless otherwise stated, adopters of IAS/IFRS should disregard the income tax provisions dealing with the characterization, classification and timing of the accrual of various items of income.
- (3) The IRES rules that remain applicable (to adopters of IAS/IFRS) are as follows:
 - (a) Provisions that set out limitations on the deductibility of items, or require a deferred deduction over a number of tax years
 - (b) Provisions whereby certain items of income are, partially or fully, exempted or excluded from income taxation or that provide for deferred taxation over a number of tax years
 - (c) Provisions whereby certain items of income are included in the business income on a cash basis (*i.e.*, upon payment or collection), irrespective of the accrual principle

The IAS/IRES Decree includes some provisions requiring that, as an exception to the general principle, the tax treatment follows the relevant legal nature rather than accounting. In particular, the legal nature of a transaction is respected for tax purposes with respect to, *inter alia*, repurchase agreements, securities lending, transactions involving equity instruments, transactions involving the availability of tax credits (or foreign tax credits), business combinations, *etc.*

3. Tax Treatment of Selected Financial Transactions

This section addresses the practical application of the above mentioned principles to certain selected financial transactions. For each transaction, first the accounting treatment is discussed and then the resulting tax consequences are addressed.

3.1 Buy-Back of Treasury Shares (and Subsequent Re-sale): the Perspective of the Issuer and the Shareholder

3.1.1 Accounting Treatment

In light of the substance over form principle, the buy-back of treasury shares by the issuer is regarded, according to IAS/IFRS, as a cancellation of the underlying instruments, notwithstanding that those instruments are not redeemed or cancelled from a legal perspective.

In particular, pursuant to IAS 32(33), if an adopter acquires its own shares (treasury shares), the consideration paid to purchase those shares should be deducted directly from equity, with no gain or loss recognized in the income statement. Accordingly, treasury shares are not recognized on the asset side of the balance sheet of the issuer after a buy-back (and are not subject to measurement at any following balance sheet date).

The re-sale of (bought-back) treasury shares is correspondingly treated as a new issue of the underlying shares by the issuer. Accordingly, the consideration received upon re-sale is recognized directly in equity as if it were the actual issue price, and no gain or loss is recognized on the income statement.

The preceding paragraphs discuss the accounting treatment of transactions involving treasury shares from the perspective of the issuer. No rule or principle under IAS/IFRS specifically deals with the accounting treatment to be adopted in those events by the counterparties of the issuer (*i.e.*, the shareholders). In normal circumstances, the accounting treatment of those transactions for the shareholders should reflect the relevant legal nature, *i.e.*, a sale or a purchase of equity instruments.

3.1.2 Tax Consequences

According to Article 83 of the Italian Income Tax Code (ITC), the characterization of these transactions in the hands of the issuer as, respectively, a cancellation and a new issue of treasury shares should be respected

for tax purposes. There is no specific rule under the IAS/IRES Decree affecting this conclusion.⁶

The tax treatment applicable to a buy-back of treasury shares and the subsequent re-sale for IRES purposes should therefore be that of cancellation of shares and issue of new shares as set out by Article 91(1)(c) and (d) of ITC whereby:

- upon cancellation of treasury shares, no taxable/deductible item of income arises in the hands of the issuer, as the difference (if any) between the purchase price paid by the issuer and the portion of net equity corresponding to the shares cancelled should not be included in taxable income; and
- upon issuance of new shares, no taxable/deductible item of income arises, as any issue price collected by the issuer (including any share premium, *i.e.*, the excess of the issue price over par value) should not be taken into account in determining its taxable income.

The above conclusions are confirmed by the accompanying report to the IAS/IRES Decree.

Uncertainties arise, however, concerning the tax characterization of the differential that results in the equity of the issuer following a buy-back and re-sale of treasury shares (such an amount being equal to the difference between the re-sale price of the treasury shares and the price paid upon buy-back). The prevailing view is that any such (positive or negative) differential is characterized, from a tax perspective, as share premium reserve (*i.e.*, a reserve including shareholders' contributions).⁷ A minority view is that any positive differential instead could be characterized as a reserve of earnings for tax purposes.⁸ The wording of the accompanying report to the IAS/IRES Decree does not address this matter extensively, but one may infer that it favours the former approach. The adoption of one approach or the other may not be tax neutral from the perspective of the shareholders (as distributions of capital reserves and of reserves of earnings are in principle subject to different tax treatment).

The above paragraphs discuss the tax treatment of transactions in treasury shares from the perspective of the issuer. In the author's opinion, for the counterparties of the issuer (*i.e.*, the shareholders), the mentioned transactions should be characterized, for income tax purposes, as a sale or purchase of shares (*i.e.*, following the relevant legal nature). This conclusion reflects the following considerations:

- (1) From the perspective of the shareholders, the accounting treatment of the mentioned transac-

tions under IAS/IFRS reflects the relevant legal characterization (see paragraph 3.1.1 above).

- (2) Moreover, according to Article 3(2) of the IAS/IRES Decree, no symmetrical income tax treatment is required for adopters of IAS/IFRS acting as counterparties in a transaction. Therefore, the fact that the buy-back (and the re-sale) of treasury shares is treated by the issuer as a cancellation (and a new issue) of the shares is of no relevance for the shareholders.
- (3) Finally, Article 3(3) of the IAS/IRES Decree provides that the tax treatment of the transactions involving equity instruments (other than treasury shares) should respect the relevant legal nature (even if this conflicts with the substance of the transaction under IAS/IFRS). Needless to say, the transactions considered here do not involve treasury shares of the shareholders.

Again, the wording of the accompanying report to the IAS/IRES Decree does not address the matter extensively, but one may infer that it supports the conclusion mentioned above. Similar views have been expressed by other tax commentators on this matter.

3.2 Bond Buy-Backs (and Subsequent Re-sale): The Perspective of the Issuer and the Bondholder

3.2.1 Accounting Treatment

In light of the substance-over-form principle, the buy-back of the issuer's own bonds (like that of treasury shares) is regarded, according to IAS/IFRS, as a redemption of the underlying instruments, notwithstanding that the instruments are not redeemed or cancelled from a legal perspective.

In particular, pursuant to IAS 39(39) and *ff.*, if an adopter acquires its own bonds, it should de-recognize the relevant liability from the liability side of its balance sheet.⁹ Under IAS 39(41), any difference between the price paid upon buy-back and the carrying value of the liability should be recognized in the income statement. Accordingly, reacquired bonds are not recognized on the asset side of the balance sheet of the issuer after the buy-back (and are not subject to measurement at any following balance sheet date). The magnitude of the differential to be recognized on the income statement of the issuer upon buy-back may vary depending upon whether the bonds are classified as "liabilities at fair

value through profit or loss"¹⁰ (measured at fair value) or as "other financial liabilities" (measured at amortized cost). In case the bonds are carried at fair value, the differential arising upon buy-back should reflect the change in fair value experienced by the instrument since the last balance sheet date while, if the bonds are carried at amortized cost, it should reflect the change in fair value experienced since the issue date.

The sale of bonds reacquired by the issuer is treated under IAS/IFRS as if the underlying bonds were re-issued; accordingly, the adopter recognizes a corresponding new liability on the liability side of the balance sheet. The specific rules dealing with the recognition and measurement of such liability vary depending upon the category in which the instrument is classified for IAS/IFRS purposes (*i.e.*, "liabilities at fair value through profit or loss" or "other financial liabilities"). This could have an impact, *inter alia*, on the accounting treatment of any differential between the re-sale price of the bonds (*i.e.*, the "deemed" issue price) and the relevant redemption amount. For instruments carried at amortized cost, this difference should influence the effective interest rate to be determined under IAS 39(9) and, consequently, should affect the amount of interest expense recognized on the income statement of the issuer (over the life of the instruments). If the financial liability is instead carried at fair value through profit or loss (FVTPL), the differential in question should not affect interest expense, but rather should affect changes in the fair value of the instruments to be recognized on the income statement of the issuer during the residual life of the bonds.¹¹

The preceding paragraphs discuss the accounting treatment of transactions in reacquired bonds from the perspective of the issuer. No rule or principle under IAS/IFRS deals with the accounting treatment to be adopted by the counterparty of the issuer (*i.e.*, the bondholders) in those events. In normal circumstances, the accounting treatment of those transactions for the bondholders should reflect the relevant legal nature, *i.e.*, a sale or a purchase of bonds.

3.2.2 Tax Consequences

According to Article 83 of ITC, the characterization of these transactions in the hands of the issuer as,

respectively, a cancellation and a new issue of bonds, should be respected for tax purposes. There is no specific rule under the IAS/IRES Decree affecting this conclusion, which is also confirmed by the commentators who have addressed the matter so far.¹²

The buy-back of bonds, in principle, triggers a taxable event in the hands of the issuer. However, the tax treatment of the differential (between the purchase price of the bonds and the relevant carrying value) recognized on the income statement of the issuer upon buy-

back depends upon the characterization of such item for accounting purposes. The particulars follow:

- (1) IAS 39 does not specifically address either the nature of the mentioned differential or the relevant classification on the income statement of the issuer.
- (2) The view of the accounting commentators is that the differential arising upon extinguishment of a financial liability should be recorded in the income statement as "finance income."¹³ The few commentators considering the matter in more detail believe that, having considered the various sub-items composing "finance income" (*e.g.*, interest, dividends, capital gains/losses, *etc.*), the differential at hand should be more akin to "capital gains and losses."¹⁴
- (3) The Bank of Italy is also in favour of characterizing this differential as a capital gain/loss. Indeed, according to the guidelines issued by the Bank of Italy (which must be respected when preparing financial statements of Italian banks), this differential is to be presented on the income statement together with capital gains and losses on financial instruments (and separately from interest income and expenses).¹⁵

The accounting characterization (and classification) of this differential as a capital gain/loss should be respected for income tax purposes. In the absence of any specific provision addressing the tax treatment of such differential, this item should ordinarily and entirely be included in the taxable income of the issuer in the tax year in which it is accounted for in the income statement according to IAS/IFRS. In the author's opinion, the different approach suggested by certain commentators¹⁶ whereby this differential could be

The IRAP taxable income of Italian companies is determined based on the aggregation of certain lines of their income statements, with very limited required adjustments.

characterized as interest expenses for income tax purposes is not correct (due to the considerations discussed in the preceding paragraphs).

As far as the tax treatment of the differential between the re-sale price of the reacquired bonds (if any) and the redemption amount of the instrument in the hands of the issuer, one should consider the following:

- (1) The tax treatment of this differential may vary based upon the relevant accounting treatment, the latter being in turn dependent on the category in which the relevant liability is recognized upon re-issue as discussed in points (2) and (3) below.
- (2) If the bonds are carried at amortized cost (being classified among “other financial liabilities”), such differential should influence the effective interest rate to be determined under IAS 39(9) and, consequently, should affect the amount of interest expense recognized on the income statement of the issuer (over the life of the instruments). This should be respected for income tax purposes. Accordingly, the interest expense recognized on the income statement of the issuer should be deductible subject to ordinary limitations applicable to such item of income (as set out, *inter alia*, by Article 96 of ITC, dealing with deduction of interest expenses). In broad terms¹⁷:
 - (a) For Italian companies (other than those described under point (b) below), net interest expense (*i.e.*, interest expense net of interest income) is normally deductible up to 30 percent of the EBITDA of the relevant company.¹⁸
 - (b) For banks and financial companies, gross interest expense (*i.e.*, interest expense gross of interest income) is deductible for an amount equal to 96 percent of the relevant amount (the remaining four percent, being normally nondeductible).
 - (c) The deduction of interest expense payable by issuers other than banks (and companies whose shares are listed on a stock exchange) is also subject to a specific cap established by an *ad hoc* tax provision.¹⁹ The general rules under points (a) and (b) above apply to the portion of interest expense within the mentioned cap (any excess over the cap amount remaining entirely nondeductible).
- (3) If the bonds are carried at fair value by the issuer (being classified among “financial liabilities at FVTPL”), the differential (between the re-sale price of the bonds and the relevant redemption amount)

should affect the changes in fair value of the instruments to be recognized on the income statement over the relevant residual life. In this case, the differential should be included entirely in the taxable income of the issuer according to the provision set out by Article 110(1-*ter*) of ITC, dealing with unrealized gains/losses on financial liabilities.²⁰

The preceding paragraphs discuss the tax treatment of transactions in reacquired bonds from the perspective of the issuer. In the author’s opinion, for the counterparties of the issuer (*i.e.*, the bondholders), these transactions should be characterized, for income tax purposes, as a sale or purchase of bonds (*i.e.*, following the relevant legal nature).²¹

3.3 Substantial Modification of the Terms of Existing Bonds: The Perspective of the Issuer

3.3.1 Accounting Treatment

Pursuant to IAS 39(40), a substantial modification of the terms of existing bonds (whether or not attributable to the financial difficulty of the debtor) shall be accounted for as an extinguishment of the original instruments and the issuance of new instruments. Under IAS 39, the terms are considered to be substantially different if the discounted present value of the cash flows on the new instruments differs by at least 10 percent from the discounted present value of the remaining cash flows on the original instruments.²²

The difference between the carrying amount of a financial liability (or part of a financial liability) extinguished and the new liability assumed, shall be recognized in the income statement.

3.3.2 Tax Consequences

The accounting characterization of the above mentioned transactions in the hands of the issuer as, respectively, a cancellation of the outstanding bonds and the issue of new bonds should be respected for income tax purposes. There is no specific rule under the IAS/IRES Decree affecting this conclusion. As far as the issuer is concerned, the same tax consequences discussed under paragraph 3.2.2 above should apply.

3.4 Convertible Bonds: The Perspective of the Issuer

3.4.1 Accounting Treatment for the Issuer

From the perspective of the issuer, bonds that are convertible at the option of the holder into a fixed

number of issuer shares (“convertible bonds”)²³ are characterized as compound instruments under IAS 32. In particular, according to IAS 32(29), a convertible bond comprises two components: a financial liability (a contractual arrangement to deliver cash) and an equity instrument (a call option granting the holder the right to convert it into shares). Pursuant to IAS 32(28),²⁴ these two components need to be accounted for separately in the financial statements of the issuer. This accounting treatment reflects the substance of the transaction which is the same as simultaneously issuing plain vanilla bonds and warrants.

Pursuant to IAS 32(31, 32), upon initial recognition, the issuer must bifurcate the convertible bond into its liability and equity components as follows:

- (1) The liability component is initially recognized for its relevant fair value (on the liability side of the financial statement). This is the present value of the stream of cash flows of the instrument (including both coupon payments and redemption amount) discounted at the market rate of interest that would have been applied to an instrument of comparable credit quality with substantially the same cash flows, on the same terms, but without the conversion feature.
- (2) The equity component is recognized in the net equity of the issuer at the residual amount resulting from the difference between the fair value of the instrument as a whole and the fair value of the liability component under point (i) above. The equity component is not recognized at its fair value, rather it is measured on a residual basis according to IAS 32(31).²⁵ This follows the principle whereby equity instruments evidence a residual interest in the assets of an entity after deducting all of its liabilities.
- (3) No gain or loss arises upon initial recognition of the two components of the convertible bond.

IAS 32 does not provide guidelines as to the presentation of the equity component in the net equity of the issuer. The commentators that have addressed the matter

have concluded that, until maturity of the convertible bond, the presentation of the equity component in the retained earnings reserve is not appropriate²⁶. This view is in line with the approach adopted in Italian market practice where the equity component is normally recognized on an *ad hoc* line of the net equity (labelled as “other equity instruments”)²⁷; the same practice is normally followed by Italian banks.²⁸

During the life of the instrument, the financial liability component is measured in accordance with IAS 39 while the equity component is not re-measured after initial recognition. In the event the financial liability component is carried at amortized cost (being classified among “other financial liabilities”),

the difference between the initial carrying value of the liability component and the redemption amount of the instrument is amortized on an effective interest basis over the residual life of the instrument (so that, at maturity, the carrying value of the liability component coincides with the redemption amount). Accordingly, the interest expense recognized on the income statement of the issuer in a given period includes the actual interest payable on the instrument and the accrued portion of the mentioned differential.²⁹

Upon maturity of the convertible bond, the embedded call option may be out of the money or in the money, and this could have different consequences:

- (1) Should the call option be out of the money, the bond is expected to be re-paid in cash. In this event:
 - (a) the issuer reverses the recognition of the financial liability component against the payment of the principal amount;
 - (b) the equity component remains in equity (although it may be reclassified from one line item of equity to another, as discussed in point (3) below); and
 - (c) in normal circumstances, no gain or loss is recognized upon redemption in cash of the bond at maturity.
- (2) Should the call option be in the money, the bondholder is expected to require the bond to be converted into shares. In this case, pursuant to IAS 32(AG39):

In light of the substance-over-form principle, the buy-back of the issuer’s own bonds (like that of treasury shares) is regarded, according to IAS/IFRS, as a redemption of the underlying instruments, notwithstanding that the instruments are not redeemed or cancelled from a legal perspective.

- (a) the issuer reverses the recognition of the financial liability component and recognizes a corresponding amount in net equity;
 - (b) the equity component remains in equity (although it may be reclassified from one line item of equity to another, as discussed in point (3) below); and
 - (c) no gain or loss is recognized upon conversion of the bond at maturity.
- (3) With respect to the accounting treatment of the equity component under points (1)(b) and (2) (b) above, based on the view expressed by the commentators³⁰ and the practice normally followed by Italian adopters on similar matters,³¹ it should follow that:
- (a) if the bond is converted into shares, the equity component is moved into the share premium reserve; while
 - (b) if the bond is redeemed in cash, the equity component is moved into the retained earnings reserve.

The accounting treatment of the convertible bond by the bondholders is beyond the scope of this article. It is worth mentioning that, from the perspective of the bondholders, the convertible bond is not treated as a compound instrument under IAS 32. Rather, the instrument is treated as a hybrid (or combined) instrument under IAS 39 that includes an embedded derivative, for which a separate accounting is required under certain conditions.³² However, the rules under IAS 39 requiring the separate accounting of embedded derivatives and financial host instruments may be substantially amended in the near future.³³

3.4.2 Tax Consequences for the Issuer

The rules under IAS 32 dealing with the bifurcation of a compound instrument into a financial liability and an equity instrument should be respected for tax purposes. There is no specific rule under the IAS/IRES Decree affecting this conclusion, which has been confirmed by commentators who have so far addressed the matter.³⁴

Should the financial liability component be carried at amortized cost (being classified among “other financial liabilities”), the accounting characterization of the differential between the initial carrying value of such component and the redemption amount of the instrument as interest expense (accruing on an effective interest basis over the life of the instrument) should be respected for tax purposes.

However, some uncertainties arise as to the tax treatment of the equity component initially recognized by the issuer in equity. This is for the following reasons:

- (1) The fact that the equity component is recognized in equity (without flowing through the income statement) does not necessarily result in the nontaxation of that component. Indeed, as a general rule, items accounted for in equity under IAS/IFRS could be relevant for income tax purposes under certain conditions (see Article 2(2) of the IAS/IRES Decree).
- (2) Moreover, the interplay between the general principle set out by Article 83 of ITC (whereby the characterization of an item under IAS/IFRS should be respected for income tax purposes) and the rule under Article 2(2) of the IAS/IRES Decree (whereby the items recognized in the equity of an adopter could be relevant for income tax purposes) is not completely clear.
- (3) Finally, there is no specific income tax provision dealing with the treatment of the equity component.

As to the tax treatment of the equity component, two possible approaches could be considered as follows:

- (1) A first approach is that the equity component is not included in the taxable income of the issuer upon initial recognition. Under that approach, the tax treatment of this item depends upon the conversion of the bond at maturity; indeed, it is only upon maturity of the bond that one may finally ascertain whether the equity component is an item of income or an equity contribution. In particular:
 - (a) If the bond is converted upon maturity, the equity component should be treated as an equity contribution by a shareholder, not being taxable for corporate income tax purposes (in light of Articles 88(4) and/or 91(1)(d) of ITC).
 - (b) If the bond is not converted at maturity, the equity component should be treated as an item of income, which should then be included in the taxable income of the issuer;
- (2) A second approach is that the equity component qualifies as an item of income upon initial recognition in equity, thus being taxable up front in the hands of the issuer.

The former approach is more appropriate for the following reasons:

- (1) According to the general principle set out by Article 83 of ITC, the characterization of an item under IAS/IFRS should be respected for income tax purposes. As confirmed by various commentators, this principle applies to all the items recognized in the financial statement of an adopter (including items recognized in equity).³⁵ Accordingly, the tax treatment of the equity component should follow the relevant characterization under IAS/IFRS whereby this is an equity instrument upon initial recognition (and not an item of income).³⁶
- (2) It is also worth mentioning that, following the approach suggested by commentators and normally adopted in Italian market practice (see paragraph 3.4.1 above), the equity component is treated (from an accounting perspective) as an equity instrument unless and until the bond is finally redeemed in cash. Only in the latter event does the equity component become an item of income and is moved to the retained earnings reserve.
- (3) Moreover, no specific income tax provision exists whereby the equity component is to be considered *per se* as an item of income for tax purposes upon initial recognition. This conclusion can be supported in light of the view expressed in the past by commentators who have addressed a similar issue concerning the tax treatment of proceeds collected by issuers upon sale of option rights to underwrite new shares in connection with a share capital increase.³⁷ In this latter case, commentators concluded that the proceeds should not be considered taxable items of income, but should instead be in the nature of an equity contribution.
- (4) The approach suggested here is also in line with the general tax principle whereby it is only upon maturity of an option-type derivative that one may determine the tax treatment of the relevant income. This is a principle that normally governs the tax treatment of premium received with respect to call and put options, as confirmed by the Italian tax authorities in the field of individual income taxation³⁸ and by the tax commentators in the field of corporate income taxation.³⁹

Italian income tax consequences of a given transaction should be ascertained taking into account the relevant accounting treatment.

- (5) This approach is also consistent with the one prevailing among commentators supporting the conclusion that the fair value of options granted by an adopter to its employees (and recognized in the income statement under IFRS

2) is treated as a deductible item of income for tax purposes.⁴⁰ Indeed, this conclusion assumes that the component recognized in the equity of the adopter (to counterbalance the recognition

of the employment cost in the income statement) is regarded as an equity contribution by the employees and thus not taxable upon initial recognition.⁴¹

For the foregoing reasons, an alternative approach that treats the equity component as an item of income upon initial recognition (being taxable up front) should be rejected. This alternative view also cannot be supported based on certain old precedents in the Italian tax courts⁴² under which the proceeds collected by an issuer upon the sale of the option rights to underwrite new shares were taxable in the hands of the same issuer. These precedents mainly relied on the argument that the relevant proceeds were not characterized as equity contributions under Italian corporate law. Needless to say, with respect to the income taxation of adopters of IAS/IFRS, what matters is the qualification of an item under IAS/IFRS (due to the general principle under Article 83 of ITC) and the Italian corporate law characterization of the same item should be disregarded.

Though the approach suggested here (whereby the equity component is not taxable up front in the hands of the issuer) is the most rational and appropriate in the author's opinion, it is fair to say that, in the absence of any official position of the Italian tax authorities, the tax treatment of the equity component is a matter which is subject to a degree of uncertainty.

If an adopter were to follow the approach whereby the tax treatment of the equity component is contingent on the conversion of the bond, this would have the following consequences:

- (1) Upon initial recognition of the bond:
 - (a) the liability component should be treated as a stand-alone liability for tax purposes; the initial carrying value of that component should be the relevant tax basis on the same date; and

- (b) the equity component accounted for in equity should not be treated as an item of income upon initial recognition (and thus not be taxable up front).
- (2) During the life of the instrument:
- (a) assuming the financial liability component is carried at amortized cost, the characterization as interest expense of the differential between the initial carrying value of such component and the redemption amount of the instrument should be respected for tax purposes,⁴³ and thus deductible in the hands of the issuer (subject to the ordinary limitations applicable to such expenses for IRES purposes, as briefly mentioned under paragraph 3.2.2 above);
- (b) the increase in the carrying value of the liability component due to the imputation of the accrued differential under point (ii)(a) above should trigger an increase in the relevant tax basis; and
- (c) the equity component should continue not to be taxable.
- (3) Upon maturity of the bond, the relevant tax consequences may vary as follows:
- (a) If the bond is not converted, the issuer should reverse recognition of the financial liability component (against the payment of the relevant redemption amount). In normal circumstances, no accounting gain or loss should be recognized in the income statement of the issuer and no taxable/deductible item of income should consequently arise. In this case, the equity

component should be moved into the retained earnings reserve and should then be included in the taxable income of the issuer.

- (b) If the bond is converted, the liability component should be reversed and a corresponding amount should be booked in equity. No gain or loss should be recognized in the income statement of the issuer and, accordingly, no taxable/deductible item of income should arise. In this event, the equity component should be moved into the share premium reserve and should not be included in the taxable income of the issuer.

4. Conclusions

For Italian adopters of IAS/IFRS, the income taxation of financial transactions follows accounting in many respects. In particular, the characterization (and the classification) of financial transactions under IAS/IFRS should normally be respected for IRES purposes.

The Italian tax treatment of any financial transaction should however be carefully considered. This is because Italian adopters of IAS/IFRS should treat a number of financial transactions based on the relevant legal nature (and irrespective of the characterization under IAS/IFRS) for IRES purposes. Moreover, some complexities arise with respect to the tax treatment of those financial transactions whose characterization (and classification) under IAS/IFRS is not addressed in detail.

ENDNOTES

¹ E.g., investment companies (so-called SIMs), asset management companies (so-called SGRs), financial companies enrolled under Article 107 of Decree 1 September 1993 no. 385 (the Italian Banking Act).

² IAS/IFRS has been introduced in the Italian accounting system by Legislative Decree 28 February 2005 no. 38.

³ The new tax rules have been enacted by Law 24 December 2008 no. 244 (the so-called 2008 Budget Law).

⁴ IRES is governed by Decree 22 December 1986 no. 917 while IRAP by Decree 15 December 1997 no. 466.

⁵ See the last sentence of Article 83 of Decree 22 December 1986 no. 917, generally referred to as the Italian Income Tax Code or "the ITC."

⁶ In particular, the provision set out by Article 2(3) of the IAS/IFRS Decree whereby the tax treatment of transactions involving equity instruments should be determined on the basis of the relevant legal nature (and irrespective

of the economic substance under IAS/IFRS) does not apply to treasury shares.

⁷ See L. Miele, *Ias, addio al doppio binario*, *IL SOLE 24 ORE*, May 25, 2009, at 5; L. Rossi, *Treatment of purchase of own shares and bonds under amendments introduced by Finance Act 2008*, *DERIVATIVES & FINANCIAL INSTRUMENTS*, July/Aug. 2008, at 168.

⁸ See P. Scarioni—S. Muni, *Operazioni sulle azioni proprie contabilizzate secondo gli IAS/IFRS: regime fiscale ed effetti sulla natura delle poste del patrimonio netto*, *BOLLETTINO TRIBUTARIO* 23, 2008, at 1814.

⁹ According to IAS 39(AG58), "if an issuer of a debt instrument repurchases that instrument, the debt is extinguished even if the issuer is a market maker in that instrument or intends to resell it in the near term."

¹⁰ This macro-category includes both liabilities held for trading and liabilities designated as fair value through profit or loss upon initial recognition.

¹¹ This is the approach suggested by a paper

prepared by the Italian Bankers' Association (see the Documento IASABI 29 April 2005 no. 16, *Manuale operativo IAS 32 e 39—Titoli e obbligazioni—Parte seconda*) in respect of the accounting treatment of issue premium and issue discount referable to debt instruments classified, by the holder of the instruments, in the asset side of the balance sheet among financial assets at FVTPL.

¹² See paragraph C.7.1 of the Circular Letter 21 February 2006 no. 3 issued by the Italian Bankers Association (ABI) and the Circular Letter 22 September 2008 no. 53 issued by the Italian Joint Stock Companies Association (Assonime), at 84.

¹³ See PWC, *IFRS MANUAL OF ACCOUNTING 2009*, CCH, 2009, ¶ 8.6.8.150, at 6284, and KPMG, *INSIGHT INTO IFRS*, Thomson, 2008/9, ¶ 3.6.1360.30, at 473.

¹⁴ See KPMG, *INSIGHT INTO IFRS*, Thomson, 2008/9, ¶¶ 3.6.1360.30, 4.6.230.10 and 4.6.540.20, at 473, 989 and 1000.

ENDNOTES

- ¹⁵ See the guidelines issued by the Bank of Italy with Circular Letter 22 December 2005 no. 262.
- ¹⁶ See Rossi, *supra* note 7, at 170.
- ¹⁷ Please note that a specific relief is available to companies belonging to a fiscal unit in respect of the deduction of interest expense.
- ¹⁸ The interest expense exceeding 30 percent of the EBITDA can be carried back/forward for a limited period of time according to specific tax provisions.
- ¹⁹ See Article 3(115) of Law 28 December 1995 no. 549, as amended by Articles 12(10) and 14(2) of Decree 21 November 1997 no. 461.
- ²⁰ In this case, the differential is not characterized as interest expense and, accordingly, the relevant deduction is not subject to the limitations provided by Article 96 of ITC.
- ²¹ This conclusion reflects arguments similar to those discussed under paragraph 3.1.2 above.
- ²² See IAS 39(AG62).
- ²³ The accounting and tax treatment of convertible securities that permit cash settlement or net share settlement for the option value is beyond the scope of this article.
- ²⁴ See IAS 32(28) whereby “the issuer of a non-derivative financial instrument shall evaluate the terms of the financial instrument to determine whether it contains both a liability and an equity component. Such components shall be classified separately as financial liabilities, financial assets or equity instruments ...”
- ²⁵ IAS 32(31) reads as follows: “equity instruments are instruments that evidence a residual interest in the assets of an entity after deducting all of its liabilities. Therefore, when the initial carrying amount of a compound financial instrument is allocated to its equity and liability components, the equity component is assigned the residual amount after deducting from the fair value of the instrument as a whole the amount separately determined for the liability component.”
- ²⁶ KPMG, *INSIGHTS INTO IFRS*, 2004, at 284, that reads as follows: “while there are no specific requirements regarding the presentation of such items within equity, details of the equity component of outstanding compound instruments should be disclosed. The equity component of compound instruments may be included in share premium, in a separate category of equity, or in capital reserves. In our view, classification as retained earnings would not be appropriate.”
- ²⁷ See, *inter alia*, the 2008 Financial Statement of Telecom Italia SpA that shows that the equity components referable to the convertible bonds issued are accounted in a specific line of the net equity labelled “other equity instruments” (“*Riserva altri strumenti rappresentativi di patrimonio netto*”).
- ²⁸ See, *inter alia*, the 2008 Financial Statement of Unicredit SpA that reads as follows “instruments convertible into treasury shares imply recognition, at the issuing date, of a financial liability and of the equity part recognized in item 150 ‘Equity instruments,’ if a physical delivery settles the contract.”
- ²⁹ This accounting treatment reflects the fact that the interest payable on a convertible bond is normally lower than that payable on a plain vanilla bond (without any conversion feature) because the holder of a convertible bond may benefit from the call option embedded in the convertible.
- ³⁰ See A. Giussani, P. Nava and A. Portaluppi, *Principi contabili internazionali*, IPSOA, 2007, at 613.
- ³¹ See the 2007 Financial Statement of Telecom Italia SpA that, in addressing the accounting treatment of the expiry of the call options granted to employees under stock option plans (that are recognized as equity components since issue date), reads as follows “when the option expires, the amount recorded in ‘Other equity instruments’ is reclassified as follows: the portion relating to exercised options is reclassified to ‘Share premium’ and the portion relating to non-exercised options is reclassified under ‘Other reserves and retained earnings (accumulated losses), including profit for the year.”
- ³² See R. Egori, *Tax Treatment of Derivatives Embedded in Hybrid Financial Instruments for Italian Adopters of IAS/IFRS*, in *DERIVATIVES & FINANCIAL INSTRUMENTS*, IBFD, Jan./Feb. 2009, at 29.
- ³³ See the Exposure Draft “Financial Instruments: Classification and Measurement” issued by the IASB in July 2009.
- ³⁴ See, *inter alia*, the Circular Letter 22 September 2008 no. 53 issued by the Italian Joint Stock Companies Association (Assonime) at 84, note 78.
- ³⁵ See R. Valacca, *Profili tributari delle imputazioni dirette a patrimonio netto*, in, no. 39, 2008, at 3183.
- ³⁶ Pursuant to IAS 32, the equity component evidences a residual interest in the assets of the issuer after deducting all of its liabilities; its carrying value is consequently determined on a residual basis upon initial recognition (see paragraph 3.4.1 above).
- ³⁷ See the Circular Letter 6 November 1996 no. 115 of the Italian Joint Stock Company Association (Assonime), at 3.
- ³⁸ See Circular Letter 24 June 1998 no. 165 whereby “the economic activity underlying option agreement should be considered as actually realized at the expiry of the option,” at which time the relevant premium is taxable or deductible.
- ³⁹ See F. Caleffi and D. Muratori, *IFA CHAIERS*, 1996, at 302, whereby “option premiums paid or received have to be capitalized and they are recognized in the taxable income only if, and when, the option is not exercised; otherwise they are added or subtracted from the price of the transaction derived from exercise of the option.”
- ⁴⁰ M. Zeppilli, *I costi del personale in forma di “stock option” secondo i principi IAS/IFRS*, *CORRIERE TRIBUTARIO* 28, 2009, at 2290; L. Miele, *Il costo delle stock option al test dell’imponibile*, *IL SOLE 24 ORE*, May 25, 2009, at 5; M. Piazza, *Determinazione del reddito d’impresa dei soggetti IAS*, *IL FISCO* 21, 2009, at 3467.
- ⁴¹ Should the counterbalancing equity component recognized in equity under IFRS 2 be treated as a taxable item of income, no net deduction would ever be available for an adopter in respect of the fair value of the options granted to its employees. In this event, indeed, the taxation of the equity component would offset the deduction of the employment cost accounted for in the income statement.
- ⁴² See the Commissione Tributaria Centrale Decision 17 December 1988 no. 8245 and Decision 7 April 1967 no. 88480.
- ⁴³ Such a differential being amortized on an effective interest basis over the residual life of the instrument under IAS 39.

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