

Tax & Legal Issues, September 2020

by Roberto Egori (Studio Legale Associato in association with Linklaters LLP)

New Italian tax ruling on corporate hybrid securities accounted as equity instruments

On 31 August 2020, the Italian tax authorities issued the public ruling No. 291/E/2020 (“**Ruling**”) addressing some aspects of the tax treatment of certain hybrid debt securities accounted as equity instruments under IAS/IFRS (“**Corporate Hybrid Securities**”) and issued by a corporate entity whose shares are listed on the Italian Stock Exchange (“**Issuer**”).

The Ruling is crucial since it confirms that the Corporate Hybrid Securities qualify as “bonds” (“*obbligazioni*”) or “debentures similar to bonds” (“*titoli similari alle obbligazioni*”) for Italian tax purposes regardless of their accounting treatment as equity instruments under IAS 32 such that:

- (i) the Corporate Hybrid Securities are eligible for the withholding tax exemption under Decree 239/1996; and
- (ii) the interest expenses due on the Corporate Hybrid Securities are deductible in the hands of the Issuer for Italian corporate income tax purposes.

1. Main features of Corporate Hybrid Securities

The main features of the Corporate Hybrid Securities can be summarized as follows:

- (i) from a civil law standpoint, the Corporate Hybrid Securities are bonds (“*obbligazioni*”) pursuant to Article 2410 and ff. of the Italian Civil Code and bear interest (at a fixed rate until a certain date which is thereafter reset for subsequent periods on the basis of the mid swap rates for Euro swap transactions with a maturity of five years plus a margin) payable annually in arrear;
- (ii) at any interest payment date, the Issuer may, at its option, elect to defer payment of the interest accrued to that date (“**Arrears of Interest**”). Arrears of Interest may, at the option of the Issuer, be paid at any time and, in any event, will become due and payable by the Issuer under certain predefined circumstances (e.g. payment by the Issuer of dividends on shares, etc.);
- (iii) the Corporate Hybrid Securities grant the bondholders with usual bondholders’ rights set out under the Italian Civil Code; therefore the bondholders will not have any control rights on the management of the Issuer or any participation rights in the economic results of the Issuer;
- (iv) the Corporate Hybrid Securities are undated obligations of the Issuer and have no fixed maturity date, but:
 - (a) may be redeemed at the option of the Issuer under certain circumstances;
 - (b) will be redeemed by the Issuer in case of liquidation of the Issuer or certain events which would lead to the liquidation of the Issuer (e.g. decision of an administrative authority, resolution of the shareholders’ meeting, opening of an insolvency proceeding).

Upon any such event, the Corporate Hybrid Securities will become due and payable at an amount equal to their principal amount, together with any accrued interest up to the redemption date and any Arrears of Interest;

- (v) the Corporate Hybrid Securities are subordinated securities and rank (a) senior to any junior securities (e.g. share capital), (b) *pari passu* with so-called “parity securities” (substantially other hybrid securities issued by the Issuer) and (c) junior in right to any other indebtedness of the Issuer.

2. Accounting treatment of Corporate Hybrid Securities

In accordance with the International Financial Reporting Standards adopted in the European Union (“IFRS”), and in particular according to IAS 32, a corporate entity issuing hybrid securities has *inter alia* to determine whether the issued securities qualify as equity instruments rather than financial liabilities. In the Ruling, the Issuer has represented that it intends to recognise the Corporate Hybrid Securities as equity instruments for accounting purposes. Such an accounting treatment is based on the following features:

- (i) the Corporate Hybrid Securities are undated perpetual securities, which will be redeemed in case of liquidation of the Issuer or certain events which would lead to the liquidation of the Issuer;
- (ii) at any interest payment date, the Issuer may, at its option, elect to defer payment of all the interest accrued to that date;
- (iii) the Issuer is not bound by any contractual obligation requiring early redemption of the Corporate Hybrid Securities, but rather has an option to redeem them under certain circumstances.

The above-mentioned accounting treatment reflects the principles under IAS 32 whereby, *inter alia*, “*a financial instrument [that] may require the entity to deliver cash or another financial asset [...] in the event of the occurrence or non-occurrence of uncertain future events (or on the outcome of uncertain circumstances) that are beyond the control of both the issuer and the holder of the instrument [...] is a financial liability of the issuer unless [...] (b) the issuer can be required to settle the obligation in cash or another financial asset (or otherwise to settle it in such a way that it would be a financial liability) only in the event of liquidation of the issuer*”.

As a consequence of the accounting treatment of the Corporate Hybrid Securities as equity instruments under IAS 32, it also follows that any interest due on such Corporate Hybrid Securities will be accounted as a direct reduction of the equity of the Issuer (and will not be recognized in the income statement of the Issuer).

3. Eligibility of Corporate Hybrid Securities for the withholding tax exemption under Decree 239/1996

While Italian tax laws expressly establish that hybrid securities (e.g. Additional Tier I) issued by Italian banks and certain other regulated entities can benefit from the so-called “**239 Tax Regime**” generally applicable to certain “*bonds and debentures similar to bonds*”, no specific tax provision grants the same regime to hybrid securities issued by Italian corporates. However, benefitting from the “239 Tax Regime” is essential for a bond to be marketable since such tax regime provides for a full domestic exemption from the 26% withholding tax otherwise applicable on payments of interest and premia, and such an exemption is in principle available to White List beneficial owners and institutional investors.

The Ruling has confirmed that hybrid securities issued by corporates are subject to the “239 Tax Regime” on the grounds that they qualify as “*bonds and debentures similar to bonds*” for Italian tax purposes regardless of their accounting treatment as equity instruments under IAS 32. In particular, the Ruling focuses on the feature of the Corporate Hybrid Securities providing an unconditional obligation to repay in full the principal amount, together with any accrued interest and any Arrears of Interest, on the redemption date. In this respect, the Ruling has also reconfirmed that subordination clauses do not undermine the unconditional obligation to repay in full the principal amount and, consequently the qualification of hybrid bonds as “*bonds and debentures similar to bonds*” for Italian tax purposes (see also Circular letter No. 306/E of 1996).

4. Italian corporate income tax treatment of interest due on Corporate Hybrid Securities

While Italian tax laws expressly allow the deductibility of interest due on hybrid securities (e.g. Additional Tier I) issued by Italian banks and certain other regulated entities, no specific rule clarifies the treatment of interest expenses due on hybrid securities issued by Italian corporates for the purposes of the Italian corporate income tax (“**IRES**”).

The Ruling has confirmed that interest due on hybrid securities issued by corporates are deductible under ordinary rules, i.e. in the amount accounted as a direct reduction of the equity of the Issuer (see Articles 109, paragraph 4 and 9 of Decree 917/1986) and within the ordinary limitations governing the deductibility of interest expenses (see Article 96 of Decree 917/1986). In this respect, the Ruling focuses on the feature that, although recognized as dividend for accounting purposes, interest expenses due on Corporate Hybrid Securities do not qualify as a remuneration for the participation rights in the economic results of the Issuer. The Ruling has also clarified that the deductibility of any interest expenses due on the Corporate Hybrid Securities is also subject to the anti-hybrid mismatch rules set out under Directive 2017/952/EU (“**ATAD 2 Directive**”), as transposed into Italian Law by way of Legislative Decree 142/2018.

Although the Ruling does not address the treatment of the interest due on the Corporate Hybrid Securities for the purposes of the Italian regional tax on productive activities (“**IRAP**”), we note that the Italian tax authorities have recently clarified that interest due on hybrid securities (e.g. Additional Tier I) issued by Italian banks and certain other regulated entities should not be deductible in the hands of the issuer for IRAP purposes (see Ruling no. 91/E of 2019). This is however a matter subject to a certain degree of subjective judgment in respect of which certain commentators have taken a different view. In any event, this interpretation should not be detrimental for ordinary corporate issuers, since the IRAP taxable base of such entities does not normally include interest expenses.