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THE TREATMENT OF DEBT IN INCOME TAXES

(*ABSTRACT*)

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This research project, which was pursued in the course of the Ph.D. programme, concerns the tax issues arising from the economic and financial condition of business debt.

In particular, it focuses on income taxation and on the different ways in which business income tax law treats taxpayers according to their different level of debt.

In Chapter 1, the starting point of the study is the examination of an economically established situation: the existence of the tax system - in particular, income taxation - is a major factor in the formation of the financial structure of enterprises; in other words, it influences the way in which enterprises raise the capital needed for their business.

Although economic and financial aspects do not fall within the scope of tax law research, Chapter 2 examines the notion of debt in this respect.

Moreover, it assesses the relationship between the raising of financial resources and the use thereof as well as the relationship between debt and equity, evaluating the conclusions reached, in economic and financial terms, as to their potential "optimal combination": such an optimal combination cannot be in fact prearranged because of the impossibility of connecting any single investment or expense with specific forms of financial resources.

This framework allows for a clear picture of the financial structure of enterprises, in respect of which the tax system seems to be both a joint cause and a corrective instrument. Historically, in fact, in Italy (and in other countries as well) the return on (and thus also the raising of) debt has received a more favourable tax treatment than the return on equity because of the general deductibility of interest expense when compared to the irrelevance of the distribution of corporate profit.

Therefore, Chapter 3 examines whether these tax provisions are consistent both with the general principles of the Italian tax system and with the conclusions reached on this issue by business sciences.
The tax analysis then goes on to focus on an income perspective, reconstructing chronologically and systematically all the provisions regulating the cost of debt in the determination of taxable business income.
It is thus found that the intrinsic features of the cost of debt - such as the absolute fungible nature of capital in relation to any type of investment - have led business taxation rules to distinguish its treatment from any other category of charge in the formation of the net taxable profit.
In particular, starting from the initial exclusion of financial charges in the original framework of the Tax on Income from Movable Wealth ("*Imposta di Ricchezza Mobile*"), interest expense was given full recognition in income terms in the Seventies on occasion of the first income tax reform, which was centred on the "derivation" of the taxable base from accounting data ("*principio di derivazione*").
On the contrary, the cost of equity was not encompassed in the determination of taxable income, being it the distribution of the overall net profit of the enterprise's business.
Nevertheless, the deductibility of the cost of debt was subsequently filtered through mechanisms designed to settle its debated relationship with the general principles of business income taxation, particularly in respect of the application (or non-application) of the "principle of pertinence" of the negative components of income ("*principio di inerenza*")[1].

[1] In accordance with the above mentioned "principle of pertinence" under the Italian business income tax regime negative components of income (costs and expenses) can be generally deducted from taxable income as long as they are "related to the business activity".

I thus examine the principle of pertinence to identify its legal and systematic foundations in the business income tax system.

After establishing the "immanent" nature of the principle of pertinence in the business income tax system, I discuss the relationship between the said principle and the cost of debt in the light of single mechanisms that restrict, through flat-rate provisions, the deductibility of interest expense: first of all, the deductibility *pro rata* and then, though solely for corporations, the flat-rate mechanism of Article 96 of Presidential Decree No. 917/1986, which is based on an economic-income parameter, *i.e.* the *Gross Operating Profit* ("*ROL*" a sort of EBITDA).

It appears that a conclusion on the principle of pertinence with respect to interest expense cannot disregard the financial relationships that characterize, in economic and business terms, the equity, debt and uses of financial resources by enterprises.

In particular, the difficult application of the principle of pertinence to interest expense arises from the impossibility to relate specific types of capital raising to distinct uses thereof.

Therefore, this conclusion has important consequences both on the substantial level of the determination of taxable business income and on the procedural level of tax assessment, even of a constitutional kind.

Chapter 4 discusses the taxation of debt from a different perspective.

The international debate that has arisen from the impact of taxes on the level of debt in the financial structure of enterprises has led to the development of several models designed to correct the effects of tax rules, in order to ensure greater "tax neutrality".

Also in Italy, as from the second half of the Nineties, special rules designed to have a direct impact on the financial structure of enterprises, have been introduced into the business income tax system.

Therefore, specific provisions have been enacted to meet the increasing demand for tax neutrality with respect to financing decisions.

Tax legislation has thus adopted an innovative approach, since the rules on business income taxation have focused also on the financial structure of the taxpayers and not only on the combination of single economic elements in the determination of the taxable profit.
The relationship between debt and equity was actually considered for the first time, even in tax terms, on the occasion of the so-called "Visco Reform"; a specific system was introduced, the *Dual Income Tax* ("DIT") that was designed to foster business capitalisation.
The rules on income taxation were subsequently and deeply changed and the "incentive" system for the use of equity under the DIT was replaced with rules that disincentived debt, such as the *Thin Capitalization Rule* ("Thincap") of the "Tremonti Reform".
The *Thincap* system was also accompanied by a further provision, called "*pro rata* patrimoniale", aimed at coordinating the deductibility of interest expense (remaining after application of the *Thincap*) with the *participation exemption* regime's scheme.
Subsequently, with the Financial Law 2008, the complex (and ineffective, in many respects) *Thincap* system was replaced with the flat-rate mechanism envisaging the limited deductibility of interest expense on the basis of the above mentioned ROL.
Lastly, after a few temporary provisions, with the so-called "Salva-Italia" Decree of December 2011, a new system was also introduced aimed at incentivizing the use of capital within companies and at contributing to a neutral treatment between debt and equity in the income taxation system. This new system, called "*Aiuto alla Crescita Economica*" ("ACE") is based on the Anglo-Saxon *Allowance for Corporate Equity* model, and consists in the tax recognition of a "notional interest", representing the return on equity invested in the company.
Each of the above mentioned systems is analysed critically, both in systematic terms, with reference to their relationship with the general

principles of business income taxation, and as regards their consistency with the theory of the financial structure developed by business science.

Also under this perspective, the analysis is further carried out by comparing the regime that applies to companies subject to IRES ("*Imposta sul Reddito delle Società*", *i.e.* Corporate Income Tax), or the former IRPEG, ("*Imposta sul Reddito delle Persone Giuridiche*") with the one that applies to entrepreneurs subject to IRPEF ("*Imposta sul Reddito delle Persone Fisiche*", *i.e.* Individual Income Tax).

It is thus argued that the various systems have been - and still are - marked by the asymmetrical treatment of different taxpayers (for which I try to find a constitutional rationale), and by inconsistencies with other income tax regulations.

In addition, the framework resulting from time to time from the various mechanisms appears to be often in contrast with the economic and business principles concerning the financial structure of enterprises.

The conclusion (Chapter 5) presents a theoretical *ridutio ad unicum* of the set of provisions governing debt in the business income tax system.

In particular, by relying on the analysis carried out, I try to reconstruct a regulatory path that has been at times tortuous and at times disordered, yet gradually oriented to the introduction of neutrality in the business taxation.

By focusing on the most critical issues, I argue that, on the one hand, for entrepreneurs subject to IRPEF, the tax recognition of interest expense remains subject to the principle of pertinence, and this might compromise the effectiveness of the cost of debt for the purposes of properly establishing net taxable income.

On the other hand, for companies subject to IRES, the system seems to be still rather distant from the objectives of tax neutrality, in particular to the extent that the limited deductibility of interest expense tends to impose a prearranged business financial structure, and the capitalisation

incentive seems limited only to some specific (and strict) forms of capital investment.