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TAX TREATMENT OF CONTRIBUTIONS OF WORK AND SERVICES TO LIMITED LIABILITY COMPANY AND STOCK CORPORATIONS

SUMMARY

BACKGROUND: *Need to protect private-sector autonomy and free competition, and need to identify clear tax rules*

In the 2003 reform of Italian corporate law, the limited liability company was seen as a model in which the partners are the central figures, and the stock corporation as a strongly capitalized enterprise in which the shareholders' personal ties – indeed, their very personalities – are played down so as to enable the enterprise to diversify its financing channels.

In the guidelines set forth in Law 366/2001, which instructed the government to produce a set of rules "such as to enable the acquisition of all elements useful for the profitable conduct of the enterprise, provided that the actual formation of share capital is guaranteed," the issues regarding the relationship between legal and tax regulations are couched in terms of "re-identifying the taxable base," hence in terms of reconstructing the basis for taxation in accordance with the new forms of organization established in corporate law.

By studying "contributions of work and services" (a new concept introduced by the reform of corporate law) to limited liability company (where they can be defined as typical) and corporations (where they are atypical, because contributors of work and services cannot subscribe capital and the corporation issues participatory financial instruments in return for their contributions), this dissertation aims to show how Italy's tax lawmakers reacted to important innovations in the typology and remuneration of contributions to corporations, and investigates the issues raised by the fact that tax law needs not only to be consistent with the overly atypical and generic rules of corporate law, but also, and still more importantly, to identify a set of regulations that guarantees that divergences between legal and fiscal notions are not too wide, and that the latter are defined clearly.

CHAPTER I
CONTRIBUTIONS OF WORK AND SERVICES AS A WAY TO FINANCE COMPANIES

1. New models for financing corporations and limited liability company
- *1.1 Models for financing corporations*
  - *1.1.1 Shares*
  - *1.1.2 Participatory financial instruments*
  - *1.1.3 Equity and loans*
  - *1.1.4 Bonds*
- *1.2 Models for financing limited liability companies*

The 2003 reform made it much easier for companies to raise funds in the capital market, by establishing a system intended to promote entrepreneurship and (as a top priority) to enlarge the range of instruments and procedures that companies can use to obtain economic resources. These objectives were achieved by recognizing new types of stocks and bonds, extending their features in various directions

and making them more flexible; and by introducing the category of financial instruments referred to in art. 2346.6 of the Civil Code.

2. *Contributions of work and services as typical in limited liability companies and atypical in corporations*
Atypical contributions of work and services to corporations
Typical contributions of work and services to limited liability companies

Contributions of work and services to corporations can be classified as "atypical allocations in kind," meaning allocations – in the broadest sense of the term, any asset transfer that satisfies an interest of the company's – that cannot be used to cover the company's nominal share capital and cannot be booked as additions to undisposable shareholders' equity.

Conversely, the admissibility of contributions of work and services to a limited liability company, and of allocating them to its capital – in limited liability companies, they are as typical as contributions in cash or kind - reflects the intention to emphasize the personalistic nature of this type of firm, where a partner's contribution is very often appreciated in light of his or her personal and professional qualities rather than for its objective value.

3. *The thin line between shareholders and investors: Interest in profits and in management of the business*

The shareholder is still someone who owns part of a company's capital, but above all the shareholder, like other investors, owns a type of financial instrument that cannot be identified in the abstract, but only on the basis of the issuing company's bylaws. The bylaws specify both the rights of the shareholders and the aspects that differentiate them from the owners of other kinds of financial instruments.

The borderline between shareholders and investors who hold other kinds of participatory financial instruments is a wavering one today, but it can nonetheless be drawn in light of the general and specific rules governing interests in the company's profits and in the management of its business.

4. *Accounting treatment of contributions of work and services*

The nature of the contribution and its susceptibility to economic valuation are relevant for determining the appropriate accounting treatment.

In corporations, such contributions figure as asset transfers that give the transferor the right to a share of the corporation's profits. The issuance of financial instruments in exchange for such atypical contributions does not increase the company's share capital, but must be described in the notes to the financial statements.

In limited liability companies, contributions of work and services are progressive. The liabilities side of the balance sheet must show the formation of capital, and the assets side must show the firm's credit for the matching value of the contribution.

At the time when a person subscribes a company's share capital, no part of his or her future allocations of work or services becomes part of the company's net worth. The only thing that becomes part of net worth is the shareholder's obligation to contribute work or services in the future. Accordingly, as the shareholder gradually fulfils this obligation, hence in consideration of the gradual provision of work or services, the company's credit with the shareholder gradually diminishes. The difference is posted in the profit-and-loss account as a cost of production, but the amount of share capital does not change.

CHAPTER II
TAX TREATMENT OF CONTRIBUTIONS OF WORK AND SERVICES TO LIMITED LIABILITY COMPANIES

1. *The difficulty of combining the principles embodied in the corporate law reform and the innovations in corporate taxation*

The reform of corporate income tax does not seem to have been guided by the need to revise tax regulations in light of the far-reaching changes in corporate law. To the contrary, tax reform seems to have followed a parallel channel that harked to its own independent source of inspiration and only occasionally intersected with the innovations in corporate law.

2. Shareholder-company relations in the evolution of the taxation of corporate profits

An examination of the 2003 reform of corporate income tax (IRES) can begin with a review of the legal and economic concepts of the corporation, which focus on balancing the need to avoid taxing distributed profits twice and the theoretical and practical needs that recommend taxing corporate profits independently. The purpose of the reform was to implement the principle of integrating the corporation's income tax and the shareholders' personal income tax by replacing the tax-credit mechanism with the exclusion of dividends from shareholders' taxable income.

The innovation thus introduced subverted the system in which shareholders were seen as taxpayers because of their status as receivers of company profits, and consequently eliminated the tax-credit mechanism. As a result, domestic and foreign dividends can now be aggregated and given a uniform treatment consisting of their exclusion from taxation.

3. The effects of contributions on share capital and on the shareholder, and their relevance for income tax purposes

Two theories on the treatment of contributions have enlivened scholarly debate ever since the days of the equity tax: the theory that contributions produce taxable income and the theory that they are made pursuant to an exchange contract. An examination of these theories led to the new wording of art. 9 of the Income Tax Code ("TUIR"), whereby in the case of a contribution in kind, income is determined by assuming that the price paid in exchange for the contribution was its "normal" (or fair market) value (This rule does not apply to listed companies).

The lawmakers' choice seems to be in line with the principle that the contribution produces taxable income. It makes it possible to identify taxable income even in the case of a contribution which, because it does not attribute any balancing item to the entrepreneur, would otherwise not be subject to taxation. This is the case when the contributor receives shares in an amount not proportional to the value of the transferred goods or rights.

The tax lawmakers decided to classify such contributions as sales. What the contributor gains in return for the sale is a share of the company's economic result (not of its business), whereas his original investment in shares gave him a right to reimbursement as well.

4. Contributions of work and services and the typical nature of their taxation

The issues involved and the different approaches taken in scholarly works and by the tax administration with regard to the taxation of contributions of work and services to limited liability companies, with particular reference to the identification of the timing of taxation, show that the application of the tax regulations to the new situations introduced by the reform of corporate law seems unable to overcome the difficulties of coordinating legal and tax legislation.

However, these difficulties can be overcome if we consider that the taxability of contributions of work and services, like other typical allocations, though outside the scope of art. 9 of the Income Tax Code, does not entail (according to the interpretation developed during this research) any particular differentiations regarding the timing of taxation, because the prevailing accounting treatment, in accordance with the principle that taxable income is the net income resulting from the profit-and-loss account, makes it possible to consider as relevant for tax purposes the moment when the cost of the shareholder's contribution is entered in the beneficiary's profit-and-loss account. This does not affect compliance with the principles for timing the booking of the individual income items referring to the contributor and taxable on the accrual basis or the cash basis, depending on whether the contributor is classified as an entrepreneur or a self-employed person.

5. Contributions of work and services to limited liability company: relevance for general partners and special partners

Tax treatment of the special partner's contribution and of the remuneration paid by the general partner

5.11. Contributions of work and services, and income paid for work done

5.1.2 Capital contributions and mixed contributions of capital and work

5.1.3 Tax treatment of contributions of capital, work and services, and of their remuneration in equity securities

Relationship between the legal treatment and the tax treatment of partnership agreements

The set of rules developed by the tax lawmakers for the treatment of partnership agreements was the result of the will to equate the remuneration of contributions made under such agreements with dividends paid to shareholders.

There thus seems to be an immediate conflict with the legal definition of the partnership agreement, which according to the prevailing orientation in doctrine and case law is not an association contract but a mutual-interest contract.

The reasons that led to rethinking this issue were probably the innovations introduced by the reform of corporate law, in particular the extension of companies' rights to create and issue equities.

Partnerships characterized by contributions consisting solely of work and services are excluded from this regime, for in this case the partnership agreement continues to be subject to the provisions of art. 53.2(c) of the Income Tax Code, because the income components are produced by the provider's activity, which is not affected by the capitalization deriving from the allocation.

Conversely, the nature of the special partner's contribution becomes irrelevant if the general partner pays for it in securities that give the special partner an interest in the partnership's economic results. The issuance of such securities is a determining factor for equating (for tax purposes) all the types of remuneration to which the special partner is entitled. The result is that if the special partner is a natural person and is not an entrepreneur, such remuneration constitutes a return on capital.

The borderline between the special partner and the shareholder thus becomes thinner, because the remuneration they receive in exchange for their different kinds of investment in the enterprise is treated in exactly the same way.

The lawmakers seem to have ignored the legal nature of the partnership agreement, but the divergence seems to fade if we consider the different perspectives in which the relationship between investors and partners is treated by the legal rules and the tax rules. The legal rules treat it from the standpoint of the effects that their remuneration produces on their participation in the business, the tax rules treat it from the standpoint of the determination of the tax charge.

CHAPTER III
TAX IMPLICATIONS OF CONTRIBUTIONS OF WORK AND SERVICES TO CORPORATIONS

1. *Deferral of taxation until the issuance of equities*

The lawmakers opted for a homogeneous treatment of remuneration paid on equities, regardless of the nature of the contribution and regardless of the reason for which it was made.

This solution, whereby contributions of work and services to corporations become taxable only at the time when the proceeds are paid and/or accrue, seems appropriate.

If a value – or, rather, an asset – resulting from an atypical allocation is not booked as the balancing entry for a capital transaction, it should not be relevant for tax purposes, because there is no need for symmetry with respect to the contributor's position.

In fact, if the taxability of the allocation – understood to all intents and purposes as a contribution to the company – is justified because new values are recognized for the beneficiary, then if no new value is recognized there will be no basis for charging tax at the time when the contribution is received.

2. *Need of symmetry between nondeductibility of the cost and nontaxability of the allocation*

Need of symmetry in the treatment of financial instruments issued by nonresident companies or organizations

Conditions for taxing remuneration paid to holders of financial instruments as dividend income

The different approaches taken by the Gallo Commission and by the delegated lawmakers with regard to the distinction between securities representing capital investments

In the context of capital investments, it is still possible to maintain, in principle, the traditional distinction between financing investments (in the broad sense of the term) and equity investments. In the former, the legal relationship underlying the investment is the relationship between obligor and obligee.

The relationship thus created justifies the borrower's duty to pay a price, in the form of interest, for the right to use the lender's capital. The amount of interest is normally independent of the results

achieved by the borrower through his management of the loaned capital, and the borrower can consider the interest he pays as a tax-deductible cost.

Conversely, if the capital investment translates into an equity investment, the relationship between the parties is not one of "otherness." The capital is not lent to a borrower; it is invested directly in a business, even if through an intermediate organizational structure in which the investor enters by virtue of the equity instrument that makes him a shareholder.

Though contributions of work and services are a new entry in the range of allocations useful for corporate financing, they are considered irrelevant for determining the tax system applicable to the equity instruments attributed to contributors. By the same token, the names of the securities attributed to individual investors are considered irrelevant. They need not belong to the macrocategories of bonds and shares, because (as in the case of contributions of work and services) the focus is on their remuneration, not their classification.

The system thus betrays the simplification objectives of Law 80/2003. Instead of being polarized around the categories of securities similar to stocks and securities similar to bonds, it continues to provide for a third category, atypical securities, which cannot be eliminated without creating gaps in the tax system.

The reform focuses on the need to tax profit at the time when it is produced and to charge the tax to the company that earned it. As a result, the subsequent distribution of dividends to shareholders is irrelevant for tax purposes. What is primarily relevant now is the nature of the remuneration due from the company and the applicable nondeductibility system. Payments on securities (shares, financial instruments and bonds) whose remuneration depends on the economic performance of the issuing company are all taxed in the same way.

3. *Equating the investor and the shareholder*

3.1 The fiscal notion of dividends and promotion of the stock company as a vehicle for raising capital

3.2 Criticism of equating the investor and the shareholder

3.3 Justification for uniform treatment of all forms of capital investment

3.4 The need to prevent occult distribution of profits in the guise of interest, and the relationship with legislation aimed at preventing undercapitalization

The corporate law reform guarantees diversification of the channels used to raise venture capital, so as to put the shareholder in a position to obtain the resources he needs for his business, even with instruments different from the traditional ones.

From the legal standpoint, this implies a sort of parallel between the shareholder and the investor, while from the tax standpoint it seems to imply the reverse. Proceeds from participatory relations are classified as profits, the aim being to promote – via tax abatement for shareholders, the related "participation exemption" and the nondeductibility of profits – wider use of the model of stock companies and their financing methods.

The legislative framework, which establishes that the nature of the contribution and any management rights attributed to investors are irrelevant, equates investors and shareholders in the treatment of all forms of capital investment that are remunerated with an interest in the company's profits.

One wonders about the reasons for this affinity. Does it suffice to refer to the need to prevent the distribution of profits in the form of interest (as a way to avoid taxes), or is it necessary to look more closely at the complex income-tax system in order to identify a common denominator that would make it possible to give a unitary character to the lawmakers' choices?

The major criticisms of the system maintain that the extension of the dividend tax system to income from other participatory financial instruments (and of partnership agreements that require capital contributions), even in cases where the holder is an independent party, is incomprehensible; such income does not have the nature of a dividend if the holder of the financial instrument is not a shareholder of the issuing company.

This extension of the dividend tax system seems still less justifiable in cases where such financial instruments are issued in exchange for contributions of work, because the proceeds paid on such instruments are not remuneration for the use of capital. In other words, such proceeds are not shares of the company's income; they are the cost of one of the factors needed to generate it.

According to this theory, if the tax system respects the rule establishing the nondeductibility of proceeds paid on financial instruments that entitle the holder to some form of control over the company

and expose him to the risk of loss, then remuneration paid to non-shareholders should be subject to the same tax regime as interest.

A different theory holds that the system set up by the lawmakers is correct, although the systematic approach that leads to substantial agreement with the legislative model does not take into account the need to fight tax evasion, which is what apparently led to equating remuneration paid to independent investors with dividends distributed to shareholders.

This latter theory starts from the observation that there is a new notion of equity income based on the way in which capital investments are remunerated. In particular, an investment of capital in a company is not differentiated according to whether the relationship between the company and the investor does or does not give the latter a set of rights suitable for steering the conduct of the business, but by the fact that the remuneration of the investment is or is not correlated to the company's economic result.

All contributions of capital are viewed as investments, not as shareholder allocations. Accordingly, since the status of shareholder (in the technical sense) is irrelevant, they are distinguished according to whether or not their remuneration is proportional to the company's positive economic result. This characteristic affects the way in which the investor's proceeds are taxed and their deductibility for the company.

The system in which interest is deductible and dividends are not is a specific choice made by the lawmakers with the aim of embodying a "realistic" logic.

According to this theory, only financial instruments that express a contribution of capital should be equated with shares. The idea is to group together (for tax purposes) only capital investments that give rise to an interest in the company's profit, whereas contributions of work and services, which do not create a refund obligation, are remunerated in the same way as self-employed work, with payments that constitute fully taxable income for the beneficiary and deductible costs for the company.

Accordingly, equating earnings from financial instruments issued in exchange for such contributions with dividends is understandable only in a *de iure condendo* perspective that identifies a "real" taxation system in which the focus shifts from the productive activity to the productive thing, and the reference framework treats all capital investments in the same way, thus equalizing the investor's level of taxation.

What fails to convince is the anti-evasion function that lawmakers attribute to equating income from all forms of capital investment to dividends. It is hard to understand why the lawmakers did not limit the nondeductibility of the remuneration of participatory financial instruments to only one case – the case in which the instrument was signed by a party who holds more than 25% of the company's capital, either directly or through a subsidiary (as defined in art. 2359 of the Italian Civil Code) – just as they acted to fight the tax-evasive use of undercapitalization, given that the stated aim of art. 98 and art. 109.9 of the Income Tax Code was to prevent the occult distribution of profits in the guise of deductible financial income.

4. *Cases in which the uniform treatment is not applicable*

An analysis of the legislation shows that the issuing company is not allowed to deduct remuneration paid to securities holders even if that remuneration is only partly related to profits, whereas equation with dividends is relevant for the security holder only if it is "totally" proportional to profits.

The result is a misalignment between the taxability of the remuneration received by the security holder and the deductibility of that remuneration for the issuing company whenever the financial instrument provides for "mixed" remuneration, meaning partly fixed and partly proportional to profits. In such cases, the remuneration is only partly nondeductible for the issuing company but does not benefit from the abatement of dividend tax.

However, the principle that economic substance (identified in the keying of remuneration to profits) prevails over legal form (the independent investor's participation in financing the business) does not justify uniform treatment of remuneration that is not keyed to profits.

5. *First overall considerations on equating remuneration for work with dividends*

5.1 The relationship established in the international accounting standards between the prevalence of the economic substance of remuneration paid to investors and the principle of the prevalence of substance over form

The legislation enacted in 2003 focuses on de-personalizing the contributor (whether shareholder or independent investor), in conformity with the altered tax rules whereby in the relationship between the

company and its shareholders, the company prevails as the centre of income production and income taxation.

In fact, the fundamental lines of the current legislation express a fiscal architecture built on the principle that income tax is charged to the company that generated the income through the conduct of its business, and that the remuneration of capital invested in the business by its shareholders is excluded from the corporate income tax charge.

The economic substance of the remuneration paid for the contribution prevails absolutely over the legal form through which the wealth produced by the company is calculated. Both in the case where the contribution gives the contributor an interest in the business and in the case where it is intended merely to finance the business, the legal forms and the accounting entries through which these equity increases are realized become nearly irrelevant for tax purposes. What is subject to taxation is the result produced by the different contributions that financed the company.

The lawmakers seem to have established in the tax system too the principle that substance prevails over form. In fact, if this principle is among the ones that underlie the international accounting standards, the strengthening of the principle that taxable income is the net income resulting from the profit-and-loss account shows that in the determination of taxable income too, the economic-substance datum can prevail over the legal datum.

This prevalence of economic substance over legal form is further confirmed by the rules governing the taxation of financial instruments owned by parties subject to the international accounting standards.

The attribution of fiscal relevance to the valuations resulting from application of the international accounting standards, and the recognition (albeit indirect) of the prevalence of economic substance over legal form, have thus partly overturned the cardinal principles of the 2003 reform of corporate taxation, at least as regards the method of taxing shareholdings and negotiable securities.

In fact, re-emerging alongside the taxation of capital gains and the deductibility of capital losses on traded securities is the taxation of dividends paid thereon.

These considerations evince the lawmakers' increasing attention to the economic results of legal acts: in identifying the applicable tax rules, the results prevail over the legal aspect.

The irrelevance of both the nature of an investment in a company and the party who makes it rules out the possibility that its legal name can have specific implications for tax purposes. What counts is whether its remuneration is or is not keyed to the economic results that the company achieves with it.

However, the problem created by establishing the prevalence of economic substance over legal form could be overcome if viewed from the standpoint of the investor, because remuneration keyed to the company's economic results and subjected to a uniform tax system – the one in which dividends are partially exempt – is in any case the effect of a single legal cause, namely the shareholders' interest and the independent investors' interest in financing the business.

CONCLUSIONS

Liberalization of the choice of instruments suitable for financing companies, and the countervailing need to typify the fiscally relevant aspects of the underlying economic phenomena: is this the beginning of a definitive divergence between legal rules and tax rules?

This research project found that under corporate law, the autonomy that market operators enjoy enables them to choose among different forms (typical or atypical) of investment in companies (which translate into multiple financing channels), and different kinds of remuneration for such investments, implies that it is left up to the market, hence to the rules of competition, to identify parties that offer better guarantees for both investors and creditors. In tax law, on the other hand, the need to typify the relevant circumstances and position them in clearly marked out frameworks implies that guarantees for investors must be sought in the not excessive fragmentation of the different methods of taxation, a circumstance that helps widen the divergence between the legal categories and the fiscal categories.

If the tax lawmakers decided that what should be taxed (via IRES) are manifestations of wealth considered in and of themselves, ignoring the personal characteristics of the persons who produced them, then their attempt to achieve substantial uniformity in the tax rules, based on the nature of the remuneration paid by the party that produced the taxed wealth, can be considered adequate to weather the changes in corporate law even if the aim of uniformity widens the gap between tax law and corporate law.