Capital strengthening of medium-sized enterprises under the Relief Decree: what are the critical issues?

The conversion into law of the Relief Decree did not make any material change to art. 26 which regulates the two tax credits introduced by the Government to remedy the undercapitalization of Italian companies. The process of converting the decree law could have been an opportunity to shed some light on the interpretative doubts and issues raised by the first commentators, in which some limitations were highlighted that may reduce the access to tax benefits by the beneficiary companies. What are the requirements to access the bonus?

Tax credits under Article 26 of the Relief Decree are measures that try to remedy the undercapitalization of Italian companies; such issue has been duly noted by Italian scholars in the past and has now gained further relevance in the current context due to the financial fragility resulting from the current economic crisis.

Potential beneficiaries of said tax credits are all corporations and cooperatives, including European ones, and stable organizations of EU companies based in Italy, which do not operate in the banking, financial or insurance sectors. In order to benefit from said tax credits, a company must meet the following requirements: it must have accrued (consolidated) revenues ranging between euro 5 and 50 million in financial year 2019 and it must have suffered, due to the epidemiological emergency from Covid-19, a reduction in revenues, compared to the same period of the previous year, of no less than 33% in March and April 2020. These rigid requirements, although understandable with a view to limiting the State’s economic burden, have the effect of excluding many companies having the same need and interest in the recapitalization, such as, for example, small-sized companies with

revenues of less than euro 5 million or companies that carry out a seasonal business.

In order to benefit from said tax credit it is necessary that a capital increase be resolved and fully paid-in in the period between the date of entry into force of the Relief Decree and December 31, 2020. In this respect, doubts have been raised in relation to the period during which the capital increase must take place, since all capital increases carried out before such period are excluded, even if they have been resolved to remedy the business crisis resulting from the Covid-19 emergency.

Article 26 of the Relief Decree provides for two forms of tax credits to incentivize the capital strengthening of Italian companies. Specifically, the subscribing shareholder is entitled to a tax credit of 20% of the contribution made and the issuing company is entitled to a tax credit of 50% of the losses incurred in excess of 10% of the net equity (gross of the losses) up to 30% of the capital increase.

Having said that, it is important to analyze some of the limitations which restrict access to the above tax benefits.

First, as to the tax credit granted to subscribing shareholders, it is envisaged that the contribution must be made in cash. The rule aims at encouraging the contribution of new resources to the issuing company that will enable it to overcome the solvency crisis caused by the Covid-19 pandemic. Therefore, in order to benefit from such tax credit, the payment of the capital increase cannot be made through contributions of assets in kind or credits. In this regard, the main doubt concerns the possibility for the subscribing shareholder to pay in the capital increase by offsetting the capital increase amount with the receivables arising from shareholders' existing loans or capital contributions. Based on the mentioned rationale and on a literal interpretation of the law, the payment of capital increases by way of set-off should be excluded, since it would not grant the company new and readily available resources. This

restrictive view, however, is not entirely persuasive, given the equally positive effects that the set-off could have in terms of capital strengthening of the company. The proposed interpretation is upheld by the prevailing notarial opinion and case law that deem the payment of capital increases in cash equivalent to the payment by set-off of shareholders' receivables for existing loans and contributions. We can therefore maintain that the payment of the capital increase by way of set-off should not preclude access to the tax credit benefit. Nevertheless, it should be noted that the set-off with shareholders' subordinated receivables (*crediti postergati*) is not unanimously accepted; hence, in such cases, it is advisable to assess whether the conditions for subordination are met and, if not, the set-off should be deemed a legitimate way of paying the capital increase, thus allowing to benefit from the tax credit.

Furthermore, it is worth considering that the maximum investment on which the tax credit can be calculated is equal to euro 2 million. Moreover, it is specified that subscribing shareholders directly or indirectly controlling, subject to common control with or affiliates to the issuing company cannot benefit from the tax credit. The aim of the Italian Government is to encourage the transfer of financial resources from private individuals to companies in a context where the economic and financial crisis resulting from the Covid-19 emergency has significantly reduced willingness to invest. However it should be noted that while minority shareholders, both as private individuals and legal entities, may benefit from the tax credit, legal entities majority shareholders are not included among the beneficiaries of said measure.

In addition, the shareholding resulting from the subscription of the capital increase must be held until December 31, 2023 (i.e. a *de facto* lock-up) and a distribution of reserves by the issuing company before such date will lead to the loss of the tax credit.

The foregoing shows how different interests and intentions between majority and minority

shareholders may jeopardise the aims of the measures set forth by Article 26. In particular, the obligation to hold the shareholding for the lock-up period may represent a critical issue for minority shareholders – who have benefited from the tax credit – as these may be forced to sell the shareholding as a result of the exercise of tag-along or drag-along rights or purchase options.

Furthermore, the distribution of reserves of any kind before expiration of the lock-up period will result in a forfeiture of the tax benefit and the obligation on the beneficiary to return the granted tax credit amount. Even then, minority shareholders may be affected by unilateral decisions of majority shareholders to distribute reserves, taking also into account that legal entities majority shareholders are not eligible for the tax benefit. Notwithstanding the foregoing, it can be argued that distributions of profits resulting from the approval of financial statements are not prevented.

In light of the above, in case of capital increase resolutions it would be advisable to encourage the cooperation between majority and minority shareholders and the entering into of specific shareholders' agreements aimed at avoiding the distribution of reserves and limiting the sale of shareholdings until expiration of the lock-up period.

As regards the tax benefit on losses granted to the issuing company, the latter is required to comply with additional conditions set forth by Article 26, Paragraph 2, lett. (a) to (f). Tax credit granted to issuing companies is unrelated to that granted to the subscribing shareholders. Indeed, if issuing companies do not meet such requirements, subscribing shareholders can nonetheless benefit from their own tax credit.

In conclusion, although the aim of the Italian Government to favour recapitalization of medium-sized companies is noteworthy, the limitations under Article 26 of the Relief Decree may have the practical effect of jeopardising its actual implementation.