

NewsAlert

Real Estate Tax Services



Italy

December 2011

The new tax regime of Italian Real Estate Investment Funds

The tax regime of Italian Real Estate Investment Funds, initially amended in May 2010, by Law Decree no. 78/2010, was increasingly reformed mid 2011, by Law Decree no. 70/2011. As of 16 December 2011, the new framework includes some explanatory provisions, issued by the Tax Office Director, which clarified some aspects of the new tax regime.

The publication of such explanatory provisions offers the opportunity to recap the changes of the last 2 years of the Italian Real Estate Investment Funds legislation.

Background

Law Decree no. 78, dated 31 May 2010 (converted with modifications into Law no. 122 dated 30 July 2010), introduced significant changes to the civil and tax frameworks of the Italian Real Estate Investment Fund (REIF).

Civil regime

Regarding the civil regime, a new definition of "Investment Fund" (*"fondo comune di investimento"*) was provided, amending the existing one by the Consolidated Law on Finance (Legislative Decree no. 58, dated 24 February 1998). This new definition better outlines the economic function of the Investment Funds. Specifically, after the amendment, the term Investment Fund identifies *"the autonomous wealth derived, through one or more issuance of units, from a plurality of investors, with the purpose of*

investing the same according to a pre-defined investment plan; divided into units pertaining to a plurality of investors; collectively managed in the interest of participants, but autonomously from them". Compared with the previous definition of Investment Fund, the following requirements were introduced: (i) collection of wealth from a plurality of investors; (ii) existence of investment programs defined in advance; (iii) management of the fund independent from participants.

For non-compliant REIFs, Law Decree no. 78/2010 provided an unfavourable tax regime based on the "plurality of investors" concept, to be defined by way of a ministerial decree. However, after approximately one year of "non-change", where the decree was not enacted and numerous drafts, forecasts and interpretations followed, a deep reform of the REIF tax regime was determined: Law

Decree no. 70, dated 13 May 2011 (converted with modifications into Law no. 106, dated 12 July 2011) introduced a tax framework only implicitly grounded on the “plurality of investors” requirement. Thus, this concept does not require a specific definition.

In addition, Law Decree no. 78/2010 provided measures to increase the separation of assets and liabilities of the Investment Fund. In fact, in addition to the existing statements that the funds’ assets are separated from those of the management company - or managed by the same - and of each unit holder, the Decree provides that the fund is solely liable for the obligations incurred on its behalf by the related management company.

A form of “deregulation” for Investment Funds “reserved” for institutional/professional investors was also been introduced. Regarding Investment Funds not subject to the rules to mitigate and diversify risks, the adoption and amendment of the fund’s rules no longer require prior approval by the regulatory authority (i.e. the Bank of Italy). In addition, fund mergers no longer have to meet regulatory provisions established for mergers between regulated funds.

Tax regime

The amendments made by Law Decree no. 78/2010 were deeply reformed by Law Decree no. 70/2011, except for the reduction of non-resident investors entitled to collected REIF profit distributions exempt from Italian withholding tax. This measure (better detailed below) is applicable to REIF profit distributions executed after the conversion of Law Decree no. 78/2010 (i.e., 30 July 2010) to the extent they refer to REIF profits accrued starting from 1st January 2010. Regarding REIF profit distribution accrued till 31st December 2009, the previous regime applies (i.e., exemption extended to all beneficial owners resident in “White Listed” countries).

The new tax regime

Law Decree no. 70/2011 confirms that REIFs are out of the scope of income taxes, but divides them into two categories, each one with a different tax regime:

- “institutional” REIFs;
- “non-institutional” REIFs.

The first category includes REIFs entirely owned by any (or a combination) of the following subjects (defined as “institutional investors”):

- a) States or public entities/bodies;
- b) Undertakings for collective investment of savings (i.e., Italian OICR, “*Organismi d’Investimento Collettivo del Risparmio*”);
- c) Pension funds;
- d) Insurance companies (only regarding investments made to cover “technical reserves”);
- e) Banks and financial intermediaries subject to “prudential supervision”;
- f) Entities indicated in letters a) through e), established in countries included in the Italian “White List” (this list includes countries with specific agreements with Italy for the exchange of tax information – EU member states are generally included) and which allow an exchange of information adequate to identify beneficial owners of income;
- g) Non-Profits/charities (i.e. private bodies and companies resident in Italy, which pursue specific mutuality purposes);
- h) Corporate and contractual SPVs owned for more than 50% by any of the entities listed under the previous letters a) to g).

Thus, the Tax Office Director’s explanatory provisions on 16 December 2011, clarified the following:

- Foreign institutional investors under letter f) includes: foreign states, foreign public bodies and foreign subjects corresponding to listed Italian entities subject to prudential supervision. This last requirement is met if the execution of the foreign subject’s activity requires prior authorisation and is subject to compulsory continuous controls according to the laws in force in the

foreign state of residence. The performance of this prudential supervision must be certified by the home country's competent supervisory authority.

- The SPVs under letter h) can be established in Italy or abroad, but limited to countries included in the "White List".
- The control on SPVs under letter h) by the subjects listed in the previous letters can also be indirect; however, regarding indirect control, the percentage of interest must be properly adjusted (e.g. an indirect control of 60% of a Luxembourg SPV through 90% of a US corporation, equates to 54% actual control of the Luxembourg SPV; conversely, an interest of 80% in a US corporation equates to an actual interest of 48%, thus not sufficient to meet the minimum control requirement).

The second category refers to REIFs also owned by other kinds of subjects.

"Institutional" REIFs

Regarding institutional REIFs, the tax regime was not changed. Therefore, REIF profits are taxed upon distribution, by way of a 20% withholding tax at source.

This withholding tax is considered an account payment for investors that generate business income and as a final payment for all other investors.

However, Italian pension funds and undertakings for collective investment of savings are exempt from the 20% withholding tax.

Regarding REIF profits distributed to investors resident in countries where a treaty against double taxation exists, the more favourable treaty regime can be claimed (in general, reference is made to provisions concerning "interest") if subjective, objective and documentary requirements are met (e.g. "beneficial owner" status; tax certificate issued by the tax authority of the country of residence of the beneficial owner, which is valid until 31 March of the year following the year it was presented).

In addition, the following non-resident investors are exempt from 20% withholding tax on REIF profit distributions:

- a) Foreign pension funds and foreign undertakings for collective investment of savings established in countries included in the "White List";
- b) International bodies established on the basis of International treaties that are valid in Italy;
- c) Central banks or entities that manage the state's official reserves.

Thus, in circular letter no. 11/E, dated 9 March 2011, the Tax Authorities clarified that investors under letter a) above are identified by way of reference to the legislation of the country where they are set up. In particular, the exemption applies to entities, regardless of their legal form; pursue the same purposes of Italian pension funds and OICRs. Conversely, formal and not substantial similarity is not sufficient for entitlement to exemption. To prevent abuse, the foreign residence and the REIF units holding period must be declared by the foreign investor.

The recent Tax Office Director's explanatory provisions confirm the above, adding the circumstance that the foreign pension fund, OICR, or the competent management entity must be subject to supervision.

Particularly, the Tax Office Director stated that, even in case of foreign pension funds and OICRs, the exemption does not apply in case of indirect investment.

"Non-institutional" REIFs

Concerning non-institutional REIFs (i.e., REIFs that are owned by one or more investors that do not fall under any of the categories stated for institutional REIFs) the three following types of investors, for which different tax regimes are provided, are identified:

- institutional investors (regardless of the REIF units percentage owned);
- other investors with no more than 5% of the REIF units;

- other investors with more than 5% of the REIF units.

The 5% threshold calculation follows these rules:

- the percentage is calculated at the end of the REIF's FY (or at the end of its management period, if shorter);
- it includes also: (i) REIF units owned indirectly by means of controlled companies/entities/bodies (reference is made to the definition of "control" provided by the Italian civil code); (ii) REIF units owned by spouses, relatives up to the third degree and relations by marriage up to the second degree (the investor has to communicate this information to the REIF's management company).

If the investor is an institutional investor or owns no more than 5% of the REIF units, REIF profits are taxed upon distribution or are tax exempt, according to the same rules applicable to institutional REIFs (treaty relief is also applicable).

Conversely, if the investor (other than an institutional investor) owns more than 5%, the profit accrued by the REIF in its annual report is attributed to this investor (in proportion to his percentage of ownership), regardless of its actual distribution.

For resident investors, the share of the accrued REIF profit must be included in the annual taxable income, to be taxed on the basis of the investor's tax regime/status (i.e., as a natural person or company). The following distribution of the REIF profit already attributed to the investors, and taxed in their hands, is consequently not subject to withholding tax.

Regarding disposal, the tax cost of the REIF units is increased (decreased) by any income (loss) passed through to the investors; it is also decreased (within the limits of the accrued profits) by the REIF profit distributed to the investors. The transfer of REIF units must be treated (for both residents and non-residents alike) as disposal of Italian partnership interests.

For non-resident investors, instead, REIF profits remain taxable upon distribution; according to the same rules applicable to institutional REIFs (treaty reliefs are applicable as well).

The Tax Office Director provided the obligation (for the REIF's management company or for the custodian bank, where applicable) to disclose in the annual withholding agent return:

- details of participants, including institutional investors, which at the end of each year, own more than 5% of the REIF units;
- income passed to the investors through the transparency system, where applicable.

One-off substitute tax

In addition to the new rules mentioned above, Law Decree no. 70/2011 has introduced (for purposes of public finance) a one-off substitute tax, which applies to non-institutional REIFs, namely to "qualified" non-institutional investors (resident and non-residents).

In particular, non-institutional investors that held (directly or indirectly, as stated above) more than 5% of the REIF units on 31 December 2010 (i.e., "qualified" non-institutional investors), must pay a one-off substitute tax equal to 5% of the average value of the REIF units held during FY 2010, as they appear in the REIF's reports for the same management period. The tax remains due even if after the reference date (i.e., end of 2010); the interest in the REIF decreased below the stated threshold.

The substitute tax can be paid either by:

- the investor, within the deadline for income tax payments for FY 2011 (i.e. ordinarily, 16 June 2012);
- the REIF management company (or custodian bank, when provided), on behalf of the investor, in 2 equal installments: 16 December 2011 (this payment can be executed by 16 January 2012, increased by interest for delayed payment) and 16 June 2012 (if the investor does not provide sufficient funds, the REIF management

company can dispose of the REIF units pertaining to the investor to pay the tax).

The tax value of REIF units is the underwriting or buying cost, or, if higher, the amount that has constituted the taxable base for this substitute tax. Any losses incurred upon sale or disposal will be irrelevant for tax purposes.

Due to the application of the substitute tax, distributions in favour of “qualified” resident/non-resident investors (holding more than 5% of the units) of REIF profits accrued until 31st December 2010 are not taxable up to the amount subject to the 5% substitute tax.

Liquidation of REIFs

As an alternative to the application of the new tax regime summarised above, non-institutional REIFs with “qualified” non-institutional investors (i.e., those subject to the new transparency taxation system) can be liquidated by 31 December 2011. The liquidation is resolved by the REIF’s management company upon the REIF unit holders meeting resolution.

The liquidation must be completed within 5 years.

In case of liquidation, the REIF management company must account for a 7% substitute tax on the NAV as of 31 December 2010. This substitute tax must be paid in three instalments:

- 40% by 31 March 2012;
- 30% by 31 March 2013;
- 30% by 31 March 2014.

The REIF management company must also account for a further substitute tax of 7% on annual profits accrued from 1 January 2011 to the end of the liquidation. This tax is due on 16 February of the year following each year for which the liquidation lasts. In this case, REIF profit distributions are not subject to withholding tax up to the amount that was subject to the substitute tax.

The tax value of REIF units is the underwriting or buying cost, or, if higher, the amount that constituted the taxable base for the substitute tax. Any losses incurred upon sale or disposal will be irrelevant for tax purposes.

In order to facilitate the liquidation, some tax relief is provided regarding indirect/transfer taxes.

Our View

The reform of the REIFs' tax regime requires a large effort regarding the assessment of investment structures' adequacy. However, due to the absence of clear and complete guidance, this work is difficult, paralysing the Italian REIF market.

The recent Tax Office's explanatory provisions provide clarity, but some of them are not welcome.

This is the case regarding the approach vis-à-vis the indirect investment into REIFs: it is accepted for the purpose of the "institutional investor" and "institutional REIF" qualification, so preventing the application of the 5% extraordinary substitute tax and the recurring taxation according to the new transparency system. Regarding withholding tax application, conversely, indirect investment does not seem to be admitted, with the consequence that a foreign institutional investor participating into Italian REIFs through a foreign SPV should not benefit from the exemption granted to institutional investors, suffering the tax liability stated for private investors.

Considering the relevance of this matter, further guidance from the competent authorities is expected. However, where investments are proposed by institutional investors, the direct investment should be preferred.

For more information, please contact your local PwC real estate tax service provider or one of the contacts below.

Global

Uwe Stoschek

Global Real Estate Tax Leader
+49 30 2636-5286
uwe.stoschek@de.pwc.com

Europe, Middle East and Africa

David Roach

Real Estate Tax Leader - EMEA
+352 49 48 48 3057
david.roach@lu.pwc.com

Central Eastern Europe

Glen Lonie

Real Estate Tax Leader - CEE
+420 251 152 619
glen.lonie@cz.pwc.com

Americas

Paul Ryan

US Real Estate Tax Leader
+1 646-471-8419
paul.ryan@us.pwc.com

AsiaPacific

KK So

Real Estate Tax Leader - AsiaPacific
+852 2289 3789
kwok.kay.so@hk.pwc.com

National

Italy

Fabrizio Acerbis

+39 (0)2 91605 001
fabrizio.acerbis@it.pwc.com

Daniele Di Michele

+39 (0)2 91605 002
daniele.di.michele@it.pwc.com